Budget 1996

Budget Plan

Tabled in the House of Commons
by the Honourable Paul Martin, P.C., M.P.
Minister of Finance

March 6, 1996

Canada

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Including Supplementary Information and Notices of Ways and Means Motions

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Introduction and Overview

Securing the Future

The 1996 budget consolidates and extends the economic and fiscal strategy set out in the 1994 and 1995 budgets. It continues the substantial progress made in the previous two budgets toward resolving the country's debt and deficit problem, ensuring that the deficit target of two per cent of GDP for 1997-98 is met. It sets the stage for the first meaningful decline in the debt-to-GDP ratio since 1974-75. It ensures that overall program spending continues to decline through 1998-99, while reallocating money toward strategic investments for the future. These include initiatives for enhanced education and employment opportunities for youths, to foster technology and innovation and to realize Canada's trade potential. Equally important, this budget responds to Canadians' concerns about the future of the public health and old age security systems.

Collectively, the three budgets are securing Canada's economic future by:

- restoring health to the nation's finances;
- defining a more appropriate role for the federal government in the modern economy and federation;
- acting to secure social programs for the future;
- enhancing support for the most vulnerable in society;

- laying out a plan to restore confidence in the old age security system; and
- reallocating spending to fund critical investments for the future.

In addition to meeting the deficit targets through 1997-98, this budget lays the groundwork for continuing fiscal progress in later years. It announces $1.9 billion in expenditure reductions in 1998-99 – of which about $260 million is reallocated to new initiatives. This leaves $1.7 billion in net spending reductions that will further reduce overall program spending. As a result, from its peak in 1992-93 program spending will fall for six consecutive years – not from some pre-budget planning level, but from the actual level of spending in the previous year. Given upward pressure on program spending over this period from transfers such as Equalization, elderly benefits and aboriginal funding, further reductions in government operations and major changes in the way the federal government does business have been required and are being delivered.

Ongoing Fiscal Progress

Financial security: continuing the pace of deficit reduction

The House of Commons Standing Committee on Finance, in publishing its advice to the government in planning the 1996 budget[1], noted that public consultations for the 1996 budget had taken place against the backdrop of "historic progress" in confronting Canada's debt and deficit problem.

The deficit was $42 billion, or 5.9 per cent of GDP in 1993-94, the year the government took office. Without fiscal action, the debt dynamic then in place would have pushed the deficit up in subsequent years. With the continued uncertainty about Canada's financial future that would have ensued, Canada's economic growth potential would have been seriously eroded.

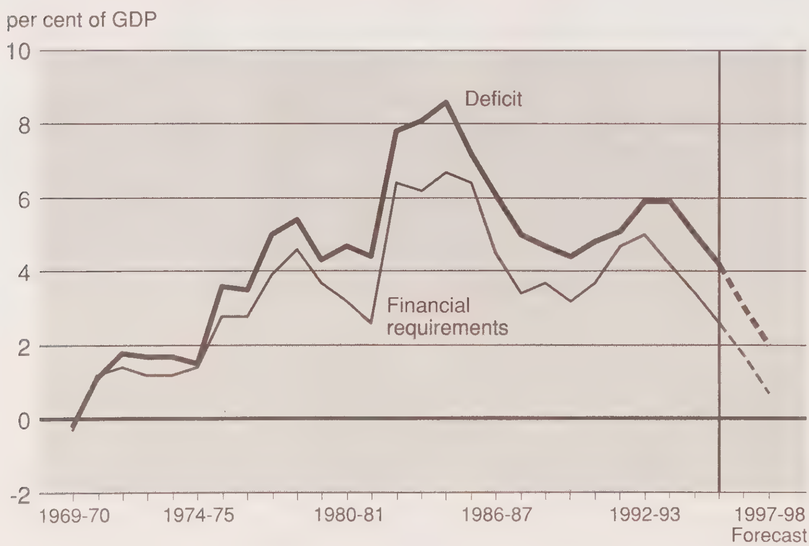
[1] Twenty-fourth report of the Standing Committee on Finance, *Building the 1996 Budget Through Consultation*, January 17, 1996.

Prudent planning and balanced actions to reduce spending are paying off. The deficit target for 1994-95 was bettered and the government is on track to meet or better the target of $32.7 billion for 1995-96. The target of $24.3 billion for the coming fiscal year will be achieved. That will cut the deficit in half from its level in 1993-94, in relation to the size of the economy (Chart 1.1).

The measured pace of deficit reduction achieved to date will continue.

The deficit target of 2 per cent of GDP, or $17 billion, for 1997-98 will be secured. Actions in this budget will ensure further reduction in the deficit the following year. Growth in public debt will slow dramatically and the debt-to-GDP ratio will fall by over one percentage point to 73.7 per cent between 1996-97 and 1997-98 – the first meaningful decline since 1974-75.

Chart 1.1
Public accounts deficit and financial requirements



Lower net borrowing in financial markets

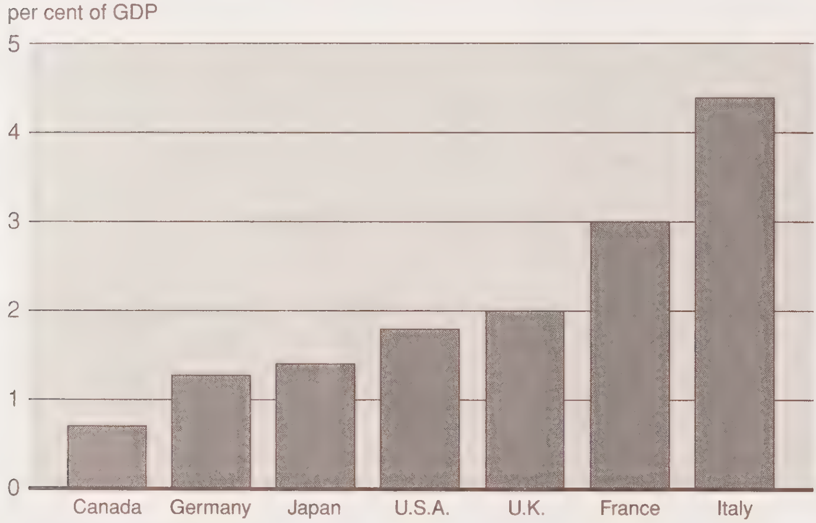
The progress in restoring financial health is also evident in the government's financial requirements, or the amount of net new borrowing in markets. Financial requirements will fall to $6 billion in 1997-98, or 0.7 per cent of GDP (Chart 1.1). This is down

sharply from almost $30 billion, or 4.2 per cent of GDP, in 1993-94 when the government took office. In relation to GDP, the 1997-98 financial requirements will be the lowest since 1969-70.

Financial requirements are comparable to the way most other major economies, including the United States, measure their deficits. On this basis, Canada is on track for the lowest fiscal shortfall in 1997 of all G-7 central governments (Chart 1.2).

Chart 1.2

Projected 1997 central government financial requirements



Source: National budget plans.

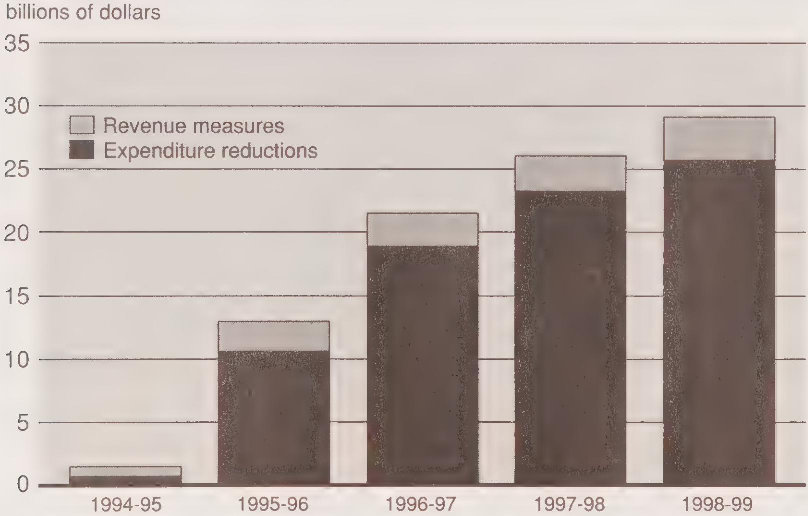
Tight control over program spending

The mix of actions between expenditure reductions and tax increases has been critical to the government's fiscal strategy. Research in Canada, and by organizations such as the International Monetary Fund, has shown that fiscal restraint arising from expenditure savings is more successful in achieving growth and a permanent improvement in the fiscal situation than that arising from revenue increases.

Fiscal actions in the government's three budgets have been achieved overwhelmingly through cuts in program spending (Chart 1.3). There were no personal tax rate increases in either the 1994 or 1995 budgets, and this budget has no tax rate increases of any kind. Of the cumulative fiscal actions from 1994-95 to 1998-99, 87 per cent have been from expenditure savings. Combined expenditure cuts from what otherwise would have been the case total $10.6 billion in 1995-96, rising to $25.6 billion in 1998-99.

Chart 1.3

Combined savings from the 1994, 1995 and 1996 budgets



As a result of actions in the 1994, 1995 and 1996 budgets, the actual level of program spending will have declined $14.5 billion – or 12.1 per cent – between 1993-94 and 1998-99 (Table 1.1).

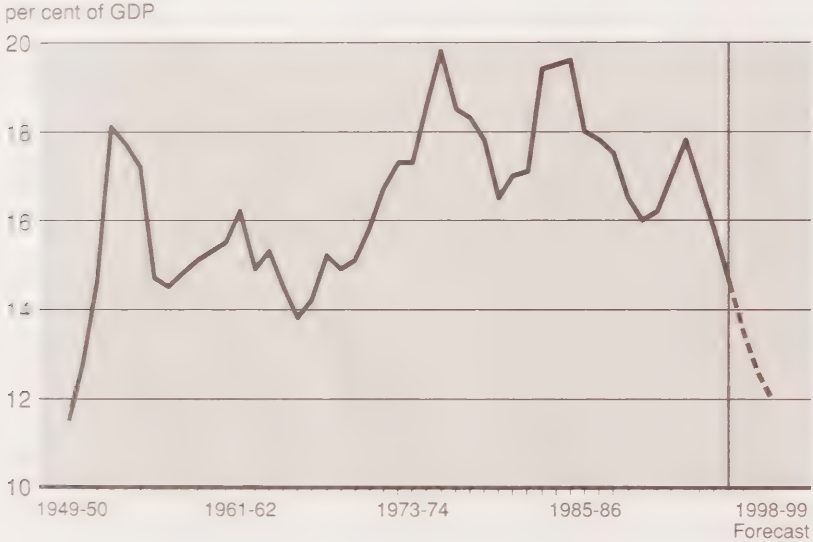
Table 1.1

Program spending

1993-94	1994-95	1995-96	1996-97	1997-98	1998-99
		(billions of dollars)			
120.0	118.7	113.8	109.0	106.0	105.5

Relative to the size of the economy, the decline in program spending is even more dramatic. It will fall from 16.8 per cent of GDP in 1993-94 to 12 per cent of GDP in 1998-99, its lowest level since 1949-50 (Chart 1.4). By 1998-99, the share of program spending in GDP will be about 60 per cent of its level in the mid-1970s and mid-1980s.

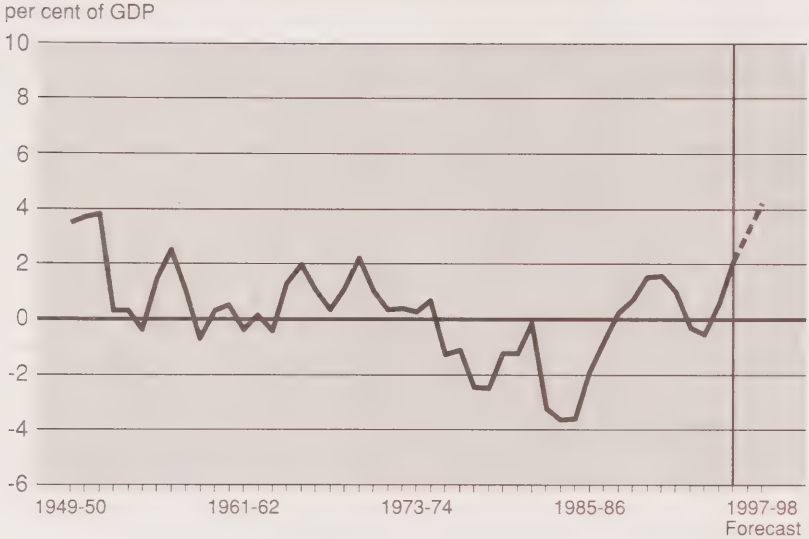
Chart 1.4
Program spending



The decline in program spending and the increase in revenue resulting from growth in the economy will result in substantial increases in the operating balance (that is, revenues less program spending). The operating balance will more than double from $16.8 billion this fiscal year to $35 billion in 1997-98 – the highest as a share of GDP since 1949-50 (Chart 1.5).

Chart 1.5

Operating balance: total revenues less program spending



Combined savings of three budgets secure ongoing fiscal progress

The 1995 and 1996 budgets have each, in turn, extended the strategy set out in the 1994 budget to get Canada's fiscal house in order. That strategy is to reduce the deficit at a steady, measured pace, through permanent reductions in spending.

The 1996 budget builds on the savings secured in the first two budgets. It respects the 1996-97 deficit target while facilitating some spending reallocation to support jobs and growth. It contributes to the 1997-98 deficit target, while facilitating further reallocation. The main focus of the 1996 budget has been to contain the potential for future increases in program spending after 1997-98, in order to ensure ongoing deficit reduction. This year's Program Review exercise reduced departmental spending by a further $1.9 billion in 1998-99, so that departmental spending is now projected to decline about 21 per cent from 1994-95 to 1998-99.

Table 1.2 shows expenditure reductions (or increases in revenues) over the three budgets from what would have otherwise been the case. The savings reported in the table are understated as they do not include the savings in public debt charges from the direct reduction in net debt arising from these measures. Nor do they include the decline in interest rates associated with the reduction in the deficit.

Table 1.2
Direct budget savings

	1994-95	1995-96	1996-97	1997-98	1998-99	Cumulative effect on net debt
			(billions of dollars)			
1994 budget	1.5	8.0	10.9	11.9	12.6	44.9
1995 budget		5.0	10.6	13.3	13.8	42.7
Total	1.5	13.0	21.5	25.2	26.4	87.6
1995 Employment Insurance reform[1]				0.7	0.8	1.5
1996 budget			0.0	0.2	1.7	1.9
Total	1.5	13.0	21.5	26.1	28.9	91.0
of which:						
Expenditures	0.7	10.6	18.9	23.3	25.6	79.0
Revenues	0.8	2.4	2.6	2.8	3.4	12.0

[1] Savings for 1996-97 were included in 1995 budget savings.

Note: Table shows net savings from deficits that would have otherwise occurred in the absence of direct measures in the budgets. Numbers may not add due to rounding.

- The 1994 and 1995 budgets contribute $13 billion in savings to achieve the 1995-96 deficit target.
- Together, the 1994 and 1995 budgets contribute the $21.5 billion needed to reach the 3-per-cent interim deficit target for 1996-97.
- Together the three budgets and Employment Insurance (EI) reform contribute $26.1 billion to secure the $17 billion deficit target for 1997-98.
- And together the three budgets will contribute $28.9 billion of savings for 1998-99. This will keep the deficit firmly on a downward track.

Cumulating these savings, net debt in 1998-99 will be $91 billion lower than would have otherwise been the case.

Improved fiscal outlook for federal/provincial government sector

Federal/provincial fiscal situation

Not only is the federal fiscal situation improving, the financial situation of the provinces and territories has also improved markedly. The combined provincial/territorial deficit has been cut by a full 50 per cent to $12.6 billion in 1995-96 from its peak of $25.1 billion in 1992-93. This is a decline from 3.6 per cent of GDP to 1.6 per cent. Moreover, eight provincial/territorial jurisdictions are expected to report a balanced budget, or even a budgetary surplus, for the fiscal year ending in March 1996. Further significant reduction in provincial deficits is anticipated for 1996-97.

In combination, the federal and provincial fiscal positions show significant fiscal redress of the total public sector in Canada:

- the aggregate deficit on a Public Accounts basis is projected to fall from 9.6 per cent of GDP in 1992-93 to 4.4 per cent of GDP in 1996-97 and less than 3 per cent the following year.
- the aggregate debt-to-GDP ratio will be put on a firm downward track, declining by nearly 2 percentage points in 1997-98.

Fiscal progress in an international context

According to the latest OECD forecast[2] and on the basis of internationally comparable (National Accounts) data, Canada's total government sector deficit is projected to improve sharply relative to the other G-7 countries.

- In 1992, the Canadian (National Accounts) deficit stood at 7.4 per cent of GDP, double the G-7 average of 3.7 per cent and second highest behind Italy.[3]
- By 1996, Canada's total government deficit will have fallen below the G-7 average to rank second lowest behind the United States.
- By 1997, the Canadian total government deficit should be well below the G-7 average based on the current plans of each country.

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[2] OECD *Economic Outlook*, December 1995.

[3] For consistency, international comparisons rely on National Accounts data. The Canadian total government sector deficit-to-GDP ratio of 7.4 per cent for 1992-93 reported here, corresponds to the Public Accounts ratio of 9.6 per cent.

Lower foreign borrowing

Lower government deficits are reducing Canada's reliance on foreign borrowing. In 1993, when the total government deficit peaked, the Canadian economy borrowed almost $29 billion from foreigners. Those funds went to finance that part of government borrowing and private investment that could not be funded at home. With reduced government borrowing requirements, the Canadian economy borrowed $13 billion from foreigners in 1995, even though private investment spending had increased substantially since 1993.

Canada's reliance on foreign borrowing will continue to decline as governments in Canada make further fiscal progress. Lower foreign borrowing will reduce the share of Canadian income that has to go abroad to service the foreign debt, thus increasing the incomes of Canadians. It will also help to improve foreign and domestic lenders' confidence in Canada and allow for greater policy independence.

1996 Budget Actions

Chapters 3, 4 and 5 describe in detail the actions being taken in this budget.

Getting Government Right

This budget announces further reductions in business subsidies, continuing privatization and commercialization in cases where a federal role is neither required nor efficient, and further restraint measures affecting lower priority programs. It introduces new, more flexible ways of doing business that will make the federal government more efficient.

Securing the future of social programs

This budget responds to Canadians' concerns about the future of Canada's health care system, post-secondary education and the security of funding for the social safety net, and takes actions to ensure the ongoing financial health of the retirement income system.

■ Funding to provinces through the Canada Health and Social Transfer (CHST) will be stabilized and then grow over the course of a new five-year funding arrangement. New funding is also being provided for research to make the health care system work better. In this way, the federal government will do its part to safeguard medicare and other social programs.

■ Following the commitment made in the 1995 budget, this budget proposes to phase in changes to the old age security system to ensure its ongoing financial health well into the 21st century. These changes provide assurance to all working Canadians that the public pension system will be there and affordable when they retire, while continuing to fully support current seniors. Proposals to improve the sustainability and fairness of the retirement income system include changes to Old Age Security and the Guaranteed Income Supplement beginning in the year 2001. Public consultations with the provinces will soon be under way on changes to the Canada Pension Plan (CPP) to ensure its sustainability.

■ The budget announces improvements to the child support system in Canada, as well as new measures to support low-income working parents with children. These include a two-step doubling of the Working Income Supplement and a modest enhancement of the child care expense deduction.

Investing in the future

The 1994 and 1995 budgets allocated resources to high-priority initiatives within a shrinking departmental portfolio. This budget continues to reallocate resources to invest in Canada's future. As part of the government's Jobs and Growth strategy, this budget announces actions that will increase the ability of Canadians to seize opportunities arising from changes in the global economy. These include initiatives to enhance education and employment opportunities of the young, to foster technology and innovation and to realize Canada's trade potential. Funds for new initiatives come from reallocations from programs of lower priority (Table 1.3).

Table 1.3
Summary of fiscal savings

	1996-97	1997-98	1998-99
	(millions of dollars)		
Expenditures			
Program Review savings	56	368	1,912
Reallocation to high priorities	-160	-210	-260
Net expenditure measures	-104	158	1,652
Revenues			
Revenue enhancement	100	245	390
Reallocation to high priorities	-30	-250	-335
Net revenue measures	70	-5	55
Total	-34	153	1,707

Note: Positive number indicates contribution to deficit reduction.

Tax measures

The government is aware of the heavy tax burden borne by Canadians and the costs this imposes on the economy. Accordingly, federal tax rates are not being raised. Mirroring the reallocation of spending, however, the budget proposes to reallocate funds among tax expenditures by tightening some preferences and redirecting the savings to high-priority areas (Table 1.4).

In particular, the government is targeting additional tax assistance to low-income parents in the work force, to students and their supporting parents or spouses, and to those making charitable donations or supporting infirm dependants.

Table 1.4
Summary of tax measures

	1996-97	1997-98	1998-99
	(millions of dollars)		
Revenue-enhancing measures			
Personal income tax			
Changes to RRSPs			
Restrict tax assistance/ non-deductibility of fees		45	180
Tax world-wide income of non-res. pensioners	10	10	10
LSVC: Restrict tax assistance	15	60	70
Measures to combat underground economy	25	60	100
Total	50	175	360
Business income tax			
Resource sector			
Repeal JEC rules	–	–	–
Tighten flow-through shares	15	20	20
Temporary tax on banks	25	40	
Overseas employment credit	10	10	10
Total	50	70	30
Total	100	245	390
Reallocation to high-priority areas			
Personal income tax			
Charitable donations	-5	-20	-20
Learning package	-5	-80	-80
Infirm credit	-5	-35	-40
Child support/ Working Income Supplement	-10	-105	-180
Total	-25	-240	-320
Business income tax			
CCA for new mines, oil sands	-5	-5	-5
Extension of 60-day flow-through share rule	–	–	–
Broaden investor base for renewable energy[1]		-5	-10
Expand flow-through shares to renewable sector	–	–	–
Total	-30	-250	-335
Net impact of revenue actions	70	-5	55

[1] The budget proposes to relax the "specified energy property" rules.

– Less then $5 million.

Summary of Fiscal Results to 1997-98

Table 1.5 shows the major fiscal results to 1997-98, including actions from this budget.

Table 1.5
Summary statement of transactions:
Fiscal outlook with budget measures

	1993-94	1994-95	1995-96	1996-97	1997-98
	(billions of dollars)				
Budgetary revenues	116.0	123.3	130.6	135.0	141.0
Program spending	-120.0	-118.7	-113.8	-109.0	-106.0
Operating balance	-4.0	4.6	16.8	26.0	35.0
Public debt charges	-38.0	-42.0	-47.0	-47.8	-49.0
Underlying deficit	-42.0	-37.5	-30.2	-21.8	-14.0
Contingency reserve			-2.5	-2.5	-3.0
Deficit	-42.0	-37.5	-32.7	-24.3	-17.0
Non-budgetary transactions	12.2	11.6	12.7	10.6	11.0
Financial requirements	-29.8	-25.8	-20.0	-13.7	-6.0
Net public debt	508.2	545.7	578.4	602.7	619.7
GDP (calendar year)	712.9	750.1	780.0	806.0	841.0
Per cent of GDP					
Revenues	16.3	16.4	16.7	16.7	16.8
Program spending	-16.8	-15.8	-14.6	-13.5	-12.6
Deficit	-5.9	-5.0	-4.2	-3.0	-2.0
Financial requirements	-4.2	-3.4	-2.6	-1.7	-0.7
Net public debt	71.3	72.8	74.2	74.8	73.7

Outline of the Budget Plan

Chapter 2 briefly describes the government's policy framework for Jobs and Growth, emphasizing the key role to be played by ensuring a healthy monetary and fiscal climate, and the appropriate role of structural policies.

Chapter 3 describes the measures being taken in this budget to make further progress in *Getting Government Right*, through actions arising from this year's Program Review. The chapter also outlines a number of tax measures to improve the integrity and fairness of the tax system, including actions to reduce the underground economy.

Chapter 4 describes actions being taken to ensure the continuity of key social programs, including the future funding for the CHST, proposals for the retirement income system, proposals to encourage charitable donations, and other actions to support children and infirm dependants.

Chapter 5 describes new initiatives to directly support jobs and growth through initiatives for education, youth employment, technology and promotion of trade through export financing.

Chapter 6 describes recent international and Canadian economic developments, and establishes the planning assumptions that underlie the fiscal projections. As in past budgets, these assumptions are based on the average of private sector outlooks with an added degree of prudence.

Chapter 7 summarizes the implications of budget actions for the fiscal outlook based on prudent economic assumptions and the inclusion of the Contingency Reserve, demonstrating that the government will meet its fiscal targets and set a course for ongoing progress.

Annex 1 describes the government's response to the 1995 *Report of the Auditor General of Canada* – in particular to his concerns regarding the burden of government debt and his observations in the 1994-95 financial statement. Annex 2 compares Canada's fiscal situation with that of the United States. Annex 3 provides an update of the fiscal situation of the total government sector in Canada in an international context. Annex 4 describes the compliance of the government with the *Spending Control Act*, and Annex 5 provides the supplementary information on tax measures contained in this budget.

2

Securing the Future

The Goals of Economic Policy

The goals of the government's economic strategy are to create more and better jobs for Canadians while securing a fair system of social programs for the future. These goals can only be achieved through healthy economic growth flowing from low interest rates, a highly productive economy, and effective government.

The policies needed are mutually reinforcing

- The elements needed to reduce interest rates – low, stable inflation and control of government deficits and debt – will also help improve productivity growth by reducing uncertainty about price levels and future tax liabilities. Lower interest rates and less uncertainty will encourage new investment in capital, technology, education and skills.
- At the same time, measures to improve productivity – helping Canadians upgrade their skills, encouraging the development and diffusion of new ideas and technologies, and developing export markets – also help to reduce the deficit and debt burden by increasing incomes.
- Only by controlling government deficits and debt, and achieving healthy economic growth can Canada afford to maintain its system of social programs.

- And, by maintaining support for those most affected by change, governments can encourage Canadians to actively participate in the ongoing evolution towards a more innovative and adaptive economy.

Creating Jobs and Growth

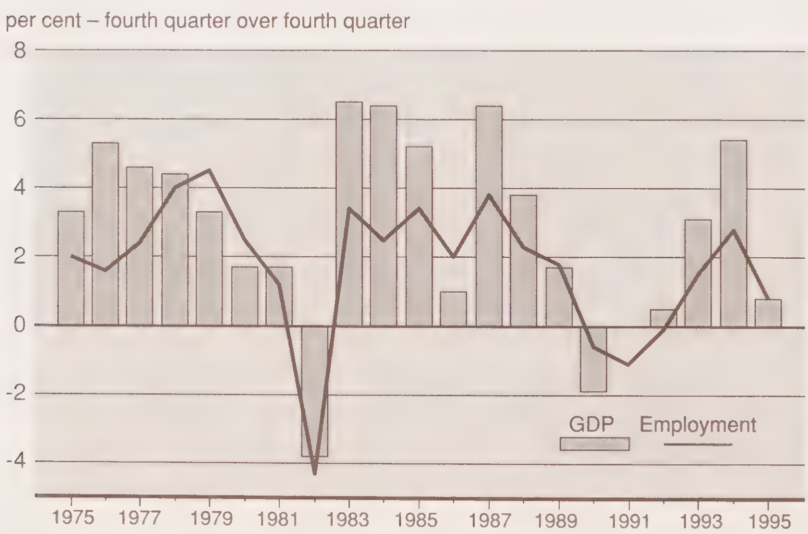
The relationship between growth and jobs

Increasingly, Canadians are concerned that the economy has changed and that economic growth will not bring with it the jobs needed for Canada's youth and those who are unemployed.

Yet, history shows there has always been a close relationship between overall growth and job creation. Healthy economic growth has always led to healthy job creation, although employment gains can lag output gains after an economic downturn.

As Chart 2.1 illustrates, recent experience is no exception. Job creation was slow to recover after the 1990-1991 recession. But that reflected, in many respects, the fact that the recovery from the 1990-1991 recession got off to a very slow start. Yet, by 1993 and 1994, as the recovery gathered momentum, so did job creation. During 1994, 442,000 full-time jobs were created, the strongest gain since 1987.

Chart 2.1
Growth in real GDP and employment in Canada



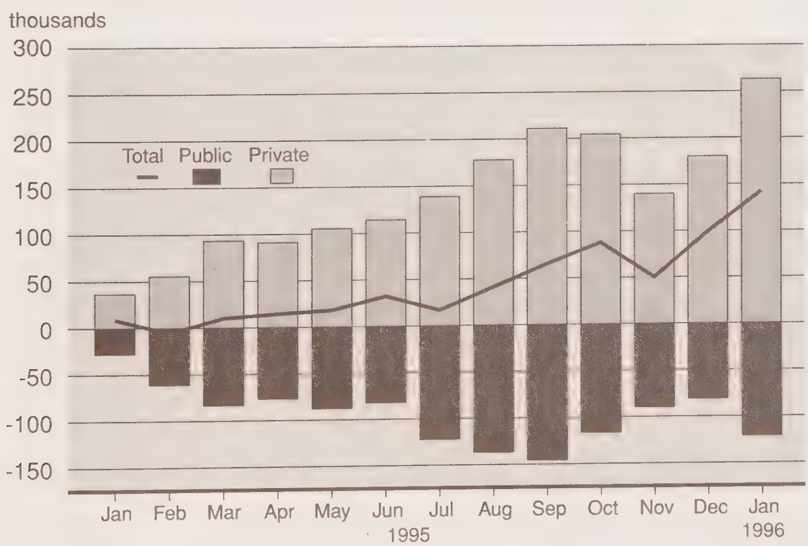
As is now the case in Canada, the U.S. also worried about a "jobless" recovery earlier in its recovery. But as U.S. growth gathered momentum in 1993 and 1994, job creation strengthened and the unemployment rate fell to its lowest level since before the onset of the 1990-1991 recession.

While overall employment gains have been weak since late 1994, job creation in the private sector has continued at a healthy pace, with 263,000 jobs created since the end of 1994 alone. However, substantial public-sector cutbacks, due to needed fiscal restraint by the federal and provincial governments, have slowed overall job creation (Chart 2.2). As the restructuring of Canada's governments matures, the strong underlying pace of private-sector job creation will show through in overall employment gains.

Yet adequate job creation will still depend on achieving better growth than in 1995. And it will not bring more jobs in all sectors and for all skill levels. Increasingly, the new jobs demand higher skills, which requires better education and training, both for youths and those already in the labour force. With a stronger economy, skilled Canadians will find it easier to find good, well-paying jobs. Indeed, the record shows that for those with good education, job creation has continued to be successful.

Chart 2.2

Cumulative employment change since December 1994



Interest rates and growth

Since the 1990-1991 recession, Canada's economy has shown diverging trends.

- On the one hand, the export-oriented sector of the economy has been strong, spurred by healthy U.S. growth in 1993 and especially in 1994, and the gains in Canada's competitiveness stemming from low inflation and only modest cost increases. As a result, export-oriented businesses are doing well, recording healthy profitability, investing in new capital, and creating new jobs.
- On the other hand, domestic-oriented sectors of the economy have yet to experience a full recovery from the 1990-1991 recession. Capacity utilization in those sectors remains low by historical standards, with the result that those businesses remain reluctant to add substantially to their productive capacity.

The slowness of the recovery in the domestic-oriented sectors of the economy partly reflects the continuing high levels of real interest rates in Canada, which are holding back demand and slowing investment. This, in turn, has slowed job creation and hurt consumer confidence.

The benefits of low interest rates

The first step in promoting healthy economic growth and creating secure jobs is to get and keep interest rates down. Low interest rates stimulate demand in interest-sensitive areas such as consumer durables and housing, as well as encouraging investment in new capital, new technologies, education and skills.

High interest rates, in contrast, are holding back the recovery in consumer demand, especially in housing markets. Indeed, the housing sector is the most obvious example of how much high interest rates have been holding back the recovery in domestic demand. A 200-basis-point increase in mortgage rates raises the cost of a $100,000 mortgage by $130 a month, or $1,570 a year. Partly in response to the increases in interest rates during 1994, Canadian housing starts declined to their lowest level in 35 years in 1995 and Canadian construction employment fell.

But high rates also hurt needed investment in new capital, technology and even worker training. This is especially true for small- and medium-sized business, because they have few alternative sources of financing. Again, a 200-basis-point increase in interest rates would raise the cost of a $2 million small-business loan by $27,000 a year.

The best way to reduce interest rates is to continue to keep inflation low and get government deficits and debts under control.

Inflation and interest rates

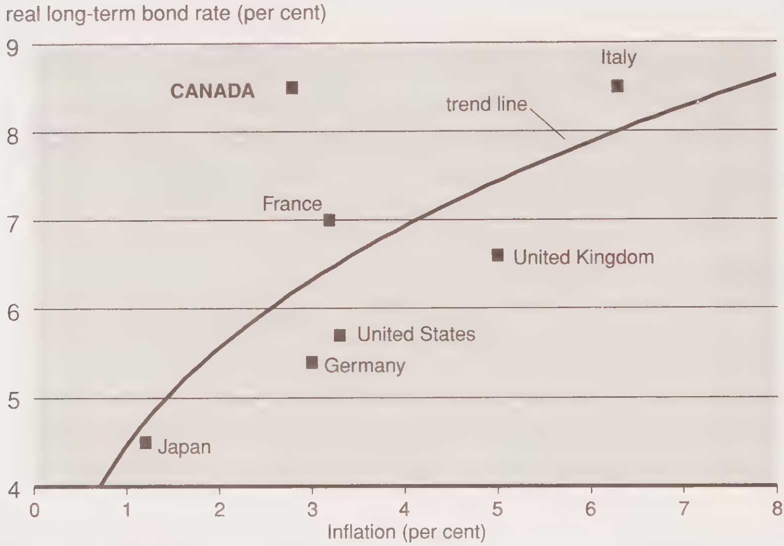
In the early 1990s, Canada paid a high price – in terms of lost output and employment – to gain the benefits of being a low inflation country. When this government came to office in late 1993, it set out to preserve those hard-won benefits by committing jointly with the Bank of Canada to maintain Canada's inflation between 1 and 3 per cent through 1998. This commitment is being kept. Canada has experienced a sustained period of low inflation that is now well within this target band. This will help to smooth the boom and bust cycles of economic activity associated with high and variable inflation, reducing the risk of investing in Canada.

The absence of domestic inflationary pressures is also playing an important role in improving Canadian competitiveness in world markets and allowing more resources to be focused on productive activities, rather than activities related to speculation. As a result, businesses are increasingly finding that Canada is a cost-effective place to invest in and produce from. The result has been soaring exports and a record merchandise trade surplus in 1995. That, in turn, has contributed to the healthy pace of job creation in the private sector in the past two years.

Keeping inflation low is the key to keeping interest rates low. This is well illustrated in Chart 2.3, which shows the relationship between real long-term interest rates and the average inflation rate in the G-7 countries. But there is more to it. Countries with low inflation can still face high interest rates for other reasons, one of which can be high fiscal deficits and debt.

Chart 2.3

Real long-term interest rates and inflation rates in G-7 countries



Interest rates are 1994 averages.

Inflation rates are the average GDP inflation rates over 1985 to 1994.

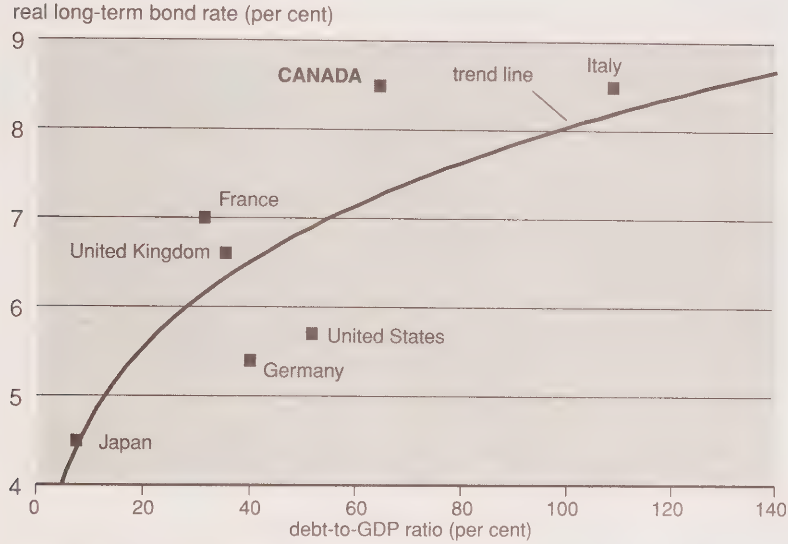
Government debt and interest rates

Canada is an example of such an economy. For the most part since the end of the 1990-1991 recession and through most of 1995, interest rates in Canada remained high relative to Canada's low inflation rate. These high "real" interest rates reflect investors' concerns about governments' abilities to meet their financial commitments if they continue to run high fiscal deficits, combined more recently with political uncertainty. High deficits have been fuelling the growth in the debt burden. Despite the progress in lowering fiscal deficits, which peaked in 1992-93, the combined debt of the federal and provincial governments has gone from 69.8 per cent of GDP before the 1990-1991 recession to 101.9 per cent in 1995-96. As a result, investors in both Canada and the rest of the world demand a risk premium on money lent to Canadian governments.

Evidence that high debts lead to high interest rates is not hard to find. Comparing debt-to-GDP ratios and interest rates across countries shows how the two are related (Chart 2.4). Canada and Italy have the highest debt-to-GDP ratios in the G-7 and the highest real interest rates (adjusted for inflation). On the other hand, Japan has the lowest debt-to-GDP ratio and the lowest real interest rates.

Chart 2.4

Real interest rates and debt-GDP ratios in G-7 countries



Interest rates are 1994 averages.

General government debt/GDP ratios are for 1994.

There is proof even closer to home, in the rates paid by provincial governments. Provinces with the lowest debt-to-GDP ratios pay the lowest interest rates, while those with the highest debt burdens tend to pay the highest rates.

This has not just been a problem for governments and financial markets. It affects all Canadians profoundly because the interest rates facing Canadian governments are the basis for rates for all borrowers in Canada. As a result, Canadian households as well as governments face higher real interest rates than in most other major countries. Equally important, many Canadian businesses face higher interest rates and, hence, higher capital costs, than their competitors. These high real interest rates have reduced consumer spending and business investment, slowing growth and job creation.

The bottom line is that, in order to get low long-term real interest rates consistent with low inflation, Canada's high debt-to-GDP ratio must be reduced.

Progress to date

The fiscal situation in Canada has improved significantly. By 1997-98, the federal deficit will have been cut to a third of its share of GDP in 1993-94. Every province or territorial jurisdiction has stated its intention to balance its deficit, with eight jurisdictions expected to post balanced budgets or surpluses in the current fiscal year.

The success of these fiscal actions, combined with continued success at keeping inflation low, helped to get Canadian interest rates down dramatically in the past year. Since their peaks in March 1995, Canadian short-term interest rates have fallen by about 300 basis points. This decline is over 250 basis points more than in the U.S and has eliminated most of the short-term interest rate differential between Canada and the U.S.

Mortgage rates are also down, with the one-year rate down 350 basis points since January 1995. For a $100,000 mortgage, this represents a savings of $2,700 per year in mortgage payments.

However, while longer-term rates are also down over 200 basis points over the same time period, they remain high relative to those in many other economies, particularly the U.S., as well as relative to Canada's inflation goals. This reflects lingering concerns over high levels of government debt, combined with continued political uncertainty.

Canadian governments must further reduce this risk premium. This means tackling the high debt burden, which is now absorbing more than a third of federal revenues, has robbed the government of fiscal flexibility, and has left the fiscal situation extremely vulnerable to economic slowdowns and increases in interest rates. Reducing the level of debt relative to our incomes requires both reducing the source of the debt – ongoing deficits – and increasing the growth potential of the economy. The faster both are done, the faster the debt burden and the risk premium will decline.

Thus, the government's focus on deficit reduction and debt control is not an end in itself, but rather *an integral part of the government's jobs and growth strategy*. This budget, combined with what the provinces are doing, should provide the confidence to reduce the risk premium on Canadian interest rates even further.

Creating a more productive economy

Low interest rates, while necessary, cannot in and of themselves generate a sustained increase in high-quality jobs for Canadians. The government recognized in its 1994 document *Agenda: Jobs and Growth, A New Framework for Economic Policy* that, to ensure more and better jobs, a more productive economy is needed. This will improve Canada's international competitiveness and thereby increase demand for Canadian goods and services. This not only will create more jobs for Canadians but it will also create better jobs for Canadians, as it is productivity gains which underlie growth in real incomes. Economies with high levels of productivity are competitive despite high wages for their workers, while economies with low productivity must compete by means of low wages.

Getting Government Right

The first step to making Canada a more productive economy is to ensure that government is itself as efficient as possible and does not hinder growth in the private sector through either its fiscal burden or ineffective policies. The dramatic changes confronting the economy, coupled with the need to reduce excessive government debt burdens, have required a revamping of government and a re-engineering of the role it plays in the economy (see Chapter 3).

Investing in the future

Yet, as part of that re-engineering, governments must recognize that they still have a key role to play in ensuring that investments which will benefit the whole economy are undertaken. That role includes:

- *investing in people*, to help Canada's youth get a good education and facilitate the transition from school to work, as well as assist existing workers and the unemployed in learning new skills that match emerging labour market needs;
- *investing in innovation*, to encourage the use of the latest ideas and technologies in the development of new and better products and processes; and
- helping to realize Canada's potential in international markets.

Securing the Future of Social Programs

The importance of Canada's social programs

One of the achievements of Canadian society is its system of social support through which Canadians pool resources in programs that benefit everyone and help to sustain people in difficult times. However, slow growth in the economy and the rising burden of interest payments on the burgeoning government debt have been a threat to the long-run viability of Canada's social support system. It is for this reason that revitalizing economic growth and controlling government deficits and debt are so important.

But Canada's social programs and system of transfers also need to be redesigned to make them more effective and more affordable. In doing so it is essential that the fundamental fairness of the social system be maintained.

Modernizing social programs

Most social programs in Canada, as in the rest of the industrialized world, were designed in the 1960s and early 1970s, when government revenues were rising strongly due to rapid economic growth. At that time, the costs of social programs were manageable and affordable.

However, economic growth has since slowed noticeably throughout the industrialized world because of both slower population growth and slow productivity gains relative to the 1950s and 1960s. This reduced government revenue growth at the same time that demand for government services was increasing with the maturing of the post-war baby-boom generation. As a result, the costs of many social programs became unsustainable in the long run. The ageing of Canadian society will put even more pressure on their sustainability in the coming decades.

This has required changes in these social programs to ensure their future, including:

- striking a delicate balance between providing support to those who need it most and creating incentives to develop alternative sources of income;

- putting in place a stable system of financing for health and social programs in partnership with the provinces, while allowing the provinces greater flexibility in the design and delivery of these programs; and
- changing the retirement income system to make it sustainable and to ensure that it is there for young- and middle-aged Canadians when they retire.

Enhancing support for the vulnerable

Many people in Canada have difficulty earning a living because of personal disabilities and changing economic times. Canadians and their governments have always felt a strong obligation to help the most vulnerable in our society. This includes helping them to integrate into the work force and providing a framework of support for the charitable organizations that play a key role in complementing government programs of support.

The Payoff: More and Better Jobs

Ultimately, securing the future for Canadians will depend on our success in creating jobs and growth and sustaining our social programs. To do that we will have to put in place a system of policies that can reinforce each other and lead to a virtuous circle of lower deficits, debt and interest rates, increased investment, more adaptability and innovation, greater productivity, and stronger growth. The end result will be more and better jobs for Canadians.

Chart 2.5

Policies are mutually reinforcing

3

Budget Measures – Getting Government Right

Plan for Action

The 1994 and 1995 budgets made major progress in turning around the deterioration in Canada's fiscal situation, while at the same time reducing waste and inefficiency and redefining and redesigning the government's programs and activities. Continuing actions to *Get Government Right* in this budget build on this progress.

- They will ensure that program spending continues to fall through 1998-99, delivering major fiscal savings into the future.
- They will further clarify the core program responsibilities of the federal government in the economy – through further reductions in business subsidies, privatization and commercialization and new partnerships with other jurisdictions.
- They will make these programs more efficient and effective in order to deliver better quality services at lower cost to the taxpayer.

These actions continue the measured approach to deficit reduction, and facilitate resource allocation to national priorities.

Program Review – a more focused, affordable government

Getting Government Right is a key ongoing theme of the government's actions in this budget. Program Review – a comprehensive review of all government programs to bring about the most effective

and cost-efficient way of delivering programs and services – was announced in the 1994 budget. It formed the cornerstone of savings in the 1995 budget through a dramatic decline in business subsidies, privatization and commercialization, a redefinition of the core responsibilities across all departments, and the elimination, redesign or consolidation of programs. It reallocated resources from lower to higher priorities.

The 1995 budget provided savings to secure the 1995-96 and 1996-97 deficit targets, but Program Review actions in that budget largely matured in 1997-98 or later[1] – part of the government's strategy to implement significant but orderly declines in program spending. The three-year planning horizon allowed departments sufficient time to plan their reforms and ensure that they were durable and would lead to permanent savings. It also allowed adjustment to these changes both within and outside the government.

With this budget, Program Review is extended to 1998-99. Some actions that mature in 1998-99 also provide fiscal savings in 1997-98. Most of these 1997-98 savings have been reallocated to high priority initiatives announced in this budget, while respecting the 1997-98 deficit target.

In addition to providing expenditure savings for this budget, Program Review has further reformed and renewed federal programming. The goal is programs that are more focused, more efficient and more affordable, and that reflect changing priorities. Additional information on the results of Program Review will be provided in a separate document to be released with the Main Estimates. Major actions with large fiscal implications are reported below.

Departmental savings from Program Review

The savings achieved in this year's continuation of Program Review are shown in Table 3.1. Resulting spending levels in federal departments are shown in Table 3.2 and Chart 3.1. As in 1995, savings vary across departments according to government priorities and the scope for program rationalization and efficiency improvements.

Program Review this year secures gross savings for 1998-99 of \$1.9 billion. It will also contribute \$368 million in additional gross

[1] Program Review savings in the 1995 budget totalled \$5.9 billion in 1996-97, and \$7.2 billion in 1997-98.

savings in 1997-98, on top of the more than $7 billion delivered for that year from last year's Program Review. These total savings from Program Review, coupled with the savings from the reform of the Employment Insurance program, secure the deficit target for 1997-98, while accommodating some new initiatives for Jobs and Growth.

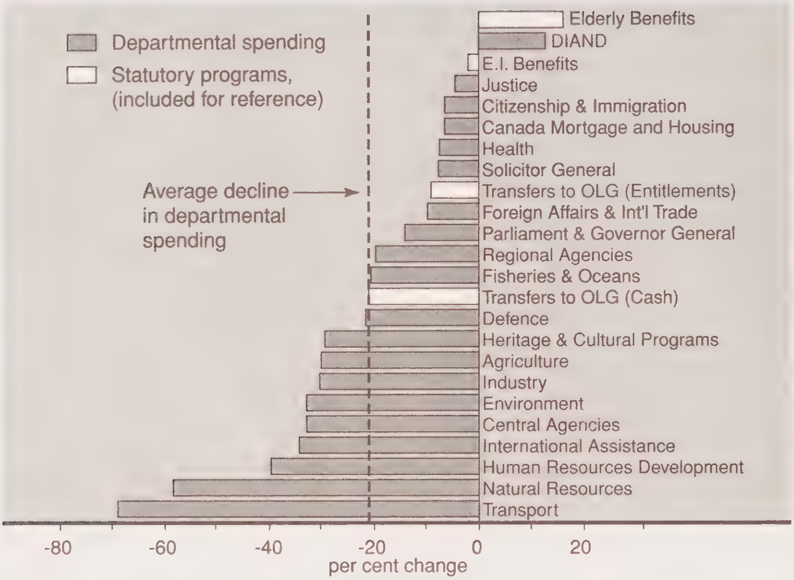
Table 3.1
Program Review departmental savings

	1997-98	1998-99
	(millions of dollars)	
Natural resource-based programs	19	204
Agriculture	19	102
Fisheries and Oceans		37
Natural Resources		47
Environment		17
Transport	34	154
Industrial, regional and scientific-technological support programs		89
Industry		71
Regional agencies		19
Justice and legal programs		100
Justice		17
Solicitor General		83
Heritage and cultural programs		133
Foreign affairs and international assistance		183
Foreign Affairs and International Trade		33
International Assistance Envelope		150
Social programs	115	316
Citizenship and Immigration		22
Health		40
Human Resources Development		74
Indian and Northern Affairs	37	78
Canada Mortgage and Housing	78	103
Defence/Emergency Preparedness	200	600
Parliament and general government services		134
Total	368	1,912

Note: Numbers may not add due to rounding.

Chart 3.1
Departmental spending

1998-99 relative to 1994-95



Federal departmental spending in 1998-99 (including funding for the new initiative outlined in Chapter 5) will be about 22 per cent lower than in 1994-95. The largest declines in spending are in departments related to economic programs. This decline partly reflects the elimination of business subsidies, which were generally administered by economic departments. For example, *Transport Canada's* budget in 1998-99 will be 69 per cent lower than in 1994-95. By 1998-99, *International Assistance* spending will have declined by over one third, and Defence spending will have declined by over $2.5 billion – over 21 per cent of its 1994-95 level.

In contrast, spending in *social* and *Justice and legal* departments will be relatively protected. Justice and legal programs will decline 7.0 per cent between 1994-95 and 1998-99. *DIAND* will be the only department where spending in 1998-99 will be higher than in 1994-95. Even including spending restraint in this and the 1995 budget, DIAND spending will grow a cumulative 12.7 per cent to 1998-99 compared to a 24.4-per-cent decline in all other departments. (Health Canada's First Nations and Inuit Health Services program will also continue to grow). The relatively smaller decline in spending by social, justice and legal departments shows that

resources within departmental spending are being allocated to areas of higher priority or need, as overall departmental spending is being reduced.

Table 3.2
Departmental spending[1]

	Spending levels		Change	
	1994-95	1998-99	$ million	per cent
Natural resource-based programs	5,524	3,564	-1,960	-35.5
Agriculture	2,080	1,455	-625	-30.1
Fisheries and Oceans[2]	1,307	1,037	-269	-20.6
Natural Resources	1,422	592	-830	-58.4
Environment	716	480	-236	-32.9
Transport[2]	2,273	704	-1,569	-69.0
Industrial, regional and scientific-technological support programs	3,822	2,760	-1,062	-27.8
Industry	2,940	2,052	-888	-30.2
Regional Agencies	882	708	-174	-19.7
Justice and legal programs	3,375	3,140	-236	-7.0
Justice	752	719	-33	-4.5
Solicitor General	2,623	2,421	-202	-7.7
Heritage and Cultural Programs	2,906	2,051	-855	-29.4
Foreign affairs and international assistance	4,374	3,232	-1,142	-26.1
Foreign Affairs and International Trade	1,464	1,320	-143	-9.8
International Assistance Envelope	2,910	1,912	-998	-34.3
Social Programs	12,641	11,664	-971	-7.7
Citizenship and Immigration	658	615	-43	-6.5
Health	1,818	1,682	-136	-7.5
Human Resources Development	2,415	1,452	-964	-39.9
Indian and Northern Affairs	3,786	4,268	481	12.7
Canada Mortgage and Housing	1,988	1,808	-180	-9.0
Veterans' Affairs	1,975	1,840	-136	-6.9
Defence/Emergency Preparedness	11,801	9,252	-2,549	-21.6
Parliament and general government services	4,635	3,979	-656	-14.1
Central Agencies	369	248	-122	-32.9
Total	51,720	40,593	-11,127	-21.5

[1] These estimates include spending on new initiatives.

[2] The Canadian Coast Guard (CCG) was part of Transport in 1994-95, and is now part of Fisheries and Oceans. For consistent year over year comparisons, CCG is included in Fisheries and Oceans for both 1994-95 and 1998-99.

Changes affecting the Public Service

The 1995 budget announced that federal employment would decline by about 45,000 jobs by the time the actions announced in that budget were fully implemented. The reduction in federal employment is on track.

Program Review actions announced in this budget will result in a further reduction in federal employment.

Changes will be made to public sector compensation which respect the context of ongoing fiscal restraint while facilitating the government's restructuring and ensuring that the government's employees are treated fairly. The President of the Treasury Board will be announcing the details of these changes shortly.

Major Program Review actions

Further reform of subsidies

The 1995 budget recognized the distorting effects of business subsidies on economic adaptation and innovation. It announced actions to sharply reduce business subsidies between 1994-95 and 1997-98. This budget announces additional actions to reform business subsidies. Grants and contributions to business will decline 61 per cent from their level in 1994-95. This includes further declines in existing subsidies (down $100 million in 1998-99 from what would have otherwise been the case) and funding for initiatives to encourage technology and innovation (see Chapter 5).

Table 3.3
Major grants and contributions to business

	1994-95	1998-99
	(millions of dollars)	
Agriculture	1,231	648
Transportation	778	7
Regional development	512	380
Industry, innovation and market development	546	313
Energy and resource sectors	515	37
Cultural industries	167	97
Total grants and contributions	3,749	1,481
Per cent reduction		61%

Note: Includes funds for initiatives to encourage technology and innovation (see Chapter 5).

The *structure* of subsidies to business will have been transformed significantly as well. Direct production subsidies will be a thing of the past. After actions in the 1995 and 1996 budgets, remaining government assistance will be largely directed to contributing to income stabilization and economic adjustments in Canadian agriculture, to supporting small business development, and to promoting and supporting, in partnership with the private sector, technological advancement and the competitiveness of Canadian industry. Program assistance directed to business development will be on more commercial terms, involving repayable forms of assistance – including royalties where appropriate – and more risk sharing by the private sector. Business assistance will be better targeted in support of the government's Jobs and Growth Strategy.

■ *Dairy Subsidy*. The dairy subsidy accounts for a significant proportion of business subsidies that remained after the 1995 budget. At that time, the government announced a 15-per-cent reduction of the dairy subsidy, effective August 1, 1995, and a further 15-per-cent reduction on August 1, 1996. The budget also indicated that the future of the subsidy would be reviewed in consultation with the industry and the provinces.

The government will phase out the dairy subsidy over five years, starting on August 1, 1997. This gradual approach builds on the reductions announced in the last budget. It reflects the government's intention to develop a new long-term dairy policy, in consultation with the industry.

The dairy industry has already achieved a high degree of co-operation among all segments of the industry in responding to the challenges of trade agreements, new national pooling systems and the national dairy code. This co-operative approach sets the stage for continued capability in the industry to work with governments to foster a strong competitive industry for the future.

■ *Postal Subsidy*. The postal subsidy program provides preferential postal rates for Canadian paid-circulation magazines, small community weekly newspapers, and library books. In addition to further reducing the program by some 18 per cent from 1997-98 to 1998-99, administrative efficiencies will be introduced to enable the program to use its resources more efficiently.

Privatization and commercialization

Privatization and commercialization, in cases where they can be shown to improve services and reduce costs while continuing to protect the public interest, have been an important aspect of Program Review. They allow departmental resources to be focused on areas where the federal government is best-placed to play a positive and effective role. And while there may not necessarily be a large budgetary gain at the time of sale, privatization and commercialization should lead to more efficient service delivery, lower financial requirements, lower debt servicing costs and lower deficits.

Significant progress has been made on the privatization and commercialization initiatives announced in the 1995 budget. All of the government's shares in *Canadian National Railways* and a substantial portion of the government's 70-per-cent interest in *Petro-Canada* were sold in public share offerings that generated net proceeds to the government of $1.2 billion and $1.7 billion, respectively. (These net proceeds will directly reduce the government's financial requirements in both 1995-96 and 1996-97. In Public Accounts terms, the transaction reduced the deficit by about $500 million, reflecting net proceeds over and above the value at which these assets were held on the government's books.) An agreement in principle has been reached to transfer Transport Canada's *Air Navigation System* to Nav Canada, a new private sector corporation controlled by stakeholders and operating on a cost recoverable, not-for-profit basis. In addition, work is advancing on examining divesting all or parts of the *Canada Communication Group*.

As well, the government has made progress on other initiatives to privatize or commercialize its operations that were announced in the 1995 budget. Examples are: property and maintenance operations in the National Capital Commission; various business services in Industry Canada; some support services on military bases, and some programs and services in Environment Canada.

The government intends to move ahead with new privatization and commercialization initiatives, while continuing to review its share holdings, assets and services for their privatization or commercialization potential.

- *Theratronics International Limited*, based in Kanata, Ontario, is a manufacturer, developer and marketer of cancer treatment and advanced computerized treatment planning systems. The sale of Theratronics International Limited will be initiated, when the company's operations warrant.

■ *National Sea Products Limited*, of Lunenburg, Nova Scotia, is one of Canada's largest producers of fish and seafood products. The government's share holding in National Sea Products Limited will be sold subject to consultations with the company and market conditions.

■ In order to continue the transformation of the western grain handling and transportation system, the government will dispose of its fleet of *grain hopper cars* and move to minimize its role in day-by-day operations of the system. The government will examine proposals for the acquisition of the cars, taking into account the interests of producers, and shippers and railways and the need to make the most efficient use of the cars. The Minister of Transport will be authorized to adjust regulated freight rates effective August 1, 1998 by $0.75 per tonne on average to cover the costs of acquisition. Required capacity for efficient grain transportation will be maintained, and legislation and regulatory reforms will be brought in to enhance the competitiveness of the Prairie grain handling and transportation system to the benefit of all participants.

■ Under the new *National Marine Policy*, the government will withdraw from the direct operation of ports, adopt a new management structure for the Great Lakes – St. Lawrence Seaway System, streamline Marine Atlantic ferry services, and introduce full cost recovery for pilotage services. When fully implemented, the new National Marine Policy will result in significant savings in the cost of essential marine services.

■ The federal government, through the Canada Mortgage and Housing Corporation (CMHC), intends to operate the *Mortgage Insurance Fund* and the *Mortgage-backed Securities Guarantee Fund* on a more commercial basis, to respond better to market changes, to improve efficiency, and to ensure a more competitive marketplace. The Mortgage Insurance Fund will continue to ensure that mortgage financing is available to home buyers in all regions of Canada.

CMHC will phase out its remaining role in social housing, except for housing on Indian reserves. The first step has already been taken – there has been no funding for new social housing units since 1993. To further clarify jurisdiction in the social housing field, the federal government is now prepared to offer provincial and territorial governments the opportunity to take over the management of existing social housing resources, provided that the federal subsidies on existing housing continue to be used for housing

assistance for low-income households. This should result in simpler administration and improved service to Canadians. The issue of the role for third parties in the administration of the social housing stock will be discussed with the provinces and territories.

Reductions in Defence expenditures

Further reductions are being made to Defence expenditures to reflect fiscal realities and the need to allocate resources to other priorities. This budget reduces defence spending from planned levels by an additional $200 million in 1997-98 and $600 million in 1998-99. These spending cuts are over and above defence expenditure reductions of $7.0 billion (over 5 years) introduced in the 1994 budget and $2.8 billion (over 4 years) in last year's budget. These successive cuts to the defence program will result in annual average reductions of almost 6 per cent over the next three years. As a result, defence spending of about $9.3 billion in 1998-99 will be more than 21 per cent lower than in 1994-95.

A leaner, more flexible and more cost-effective defence capability will result from these actions. The changes will be implemented mainly through a reduction in planned capital equipment expenditures, some additional minor reductions to military and civilian personnel and some further reductions in infrastructure.

Lower spending on International Assistance

Spending under the International Assistance Envelope will be reduced by $150 million from its planned level of $2.1 billion in 1998-99. Canada will still deliver an effective aid program of almost $2 billion to assist developing countries. This will be delivered through a more streamlined program that better reflects Canada's current fiscal capacities. While Canada's aid program is being reduced substantially in recognition of limited financial resources, it is being reduced from a high level (the second highest among the G-7 as a proportion of the economy and well above the average for the OECD countries) to a more affordable level. Most other G-7 countries are also reducing their aid programs in the face of fiscal constraints. While Canada's ODA-to-GNP ratio will decline as a result, it will still be comparable to the G-7 average. As indicated in *Canada in the World*[2], the government is committed to making progress towards the ODA target of 0.7 per cent of GNP when Canada's fiscal situation allows.

[2] Government of Canada, *Canada in the World*, 1995.

Aboriginal spending

Spending on Indian and Inuit programming (excluding land claims and northern programs) for the Department of Indian Affairs and Northern Development will increase by 2 per cent in each of 1997-98 and 1998-99. This follows growth of 3 per cent in 1996-97. Spending in Health Canada on First Nations and Inuit Health Services will grow by approximately 1 per cent in 1998-99, after two years of growth at 3 per cent.

These restraint measures will help ensure that programs will be more affordable over the long term, while allowing for a modest increase in spending to take account of the growing client population. The government's goal is more efficient delivery of programs and services to clients while, at the same time, maintaining access to these services.

Lower spending on VIA Rail

New measures to improve productivity will permit savings of $63.5 million in VIA's operating subsidy, starting in 1998-99. Further options will be examined for achieving greater efficiency in the delivery of passenger rail service.

Lower spending on AECL

Atomic Energy of Canada Limited (AECL) receives support from the federal government for nuclear research and development. This funding is used mainly to support Candu and other basic nuclear science. AECL's federal funding will be $174 million in 1996-97, and is scheduled to fall to $132 million by 1997-98. As a result of Program Review, an additional $32 million in direct federal funding will be eliminated by 1998-99.

3.5-per-cent efficiency savings

The government's continuing efforts to improve efficiency and eliminate waste in public administration have resulted in significant savings in departmental spending. More can and will be done to reduce departmental spending. To ensure that these efforts continue, departmental budgets are being reduced by an average of 3.5 per cent in 1998-99. These reductions, applied to departmental spending other than major statutory transfers, contribute

$770 million to the overall savings of $1.9 billion in departmental spending. These efficiency savings will be achieved through further economies in program delivery, and in particular, lower administration or overhead costs.

New ways of doing business

Alternative Service Delivery

As part of Program Review, all federal departments were asked to review their programs and activities to ensure that the government's diminished resources are directed to the highest priorities of Canadians and to those areas where the federal government is better placed than any other entity to deliver a service. A central objective of Program Review was also to identify the most cost-effective ways of delivering federal programs.

The government is making progress in exploring ways to improve the delivery of services and reduce costs. This has already led to a major redefinition of the role of the federal government in several areas including transportation, agriculture and industry. Moreover, departments across government have been taking initiatives to provide services in new ways. One of the most innovative examples is the network of Canada Business Service Centres, which provide a single access point for information on federal, provincial and municipal programs and services of interest to business. Another example is the Passport Office which, as a special operating agency, is striving to develop a focus on service through declared service standards.

The essence of these changes is to give service delivery organizations greater autonomy to provide their services in ways that are more responsive to the needs of their clients and that are more cost effective.

As the government continues to make progress in moving services to alternative models of delivery, it is necessary to introduce measures that ensure employees are treated fairly and responsibly in the transfer arrangements. Accordingly, legislation is being introduced to facilitate the transfer of public servants to other organizations.

Single Food Inspection Agency

Legislation will be introduced in the course of 1996 to create several new service agencies. One example is a Single Food Inspection Agency which will regroup food inspection and quarantine-related services currently provided in three federal departments into one single agency which will report through the Minister of Agriculture and Agri-Food Canada. The agency will facilitate the transition to greater provincial participation, leading to a truly national system by offering new possibilities for entering into partnerships with provinces. It will also provide a vehicle for strengthening industry involvement. The agency will realize significant cost savings and other efficiencies by eliminating interdepartmental overlap and duplication in areas such as legislation, enforcement, risk management, laboratory services, informatics systems, and communications. Responsibility for food safety policy and related activities will be consolidated in Health Canada.

Parks Canada Agency

A Parks Canada agency will be established as a separate service agency to manage, and preserve for future generations, a system of national parks, national historic sites and canals and related protected areas for the use and enjoyment of Canadians. The agency will provide better services to Canadians and visitors through simplified human resource and administrative rules and more flexible financial authorities. A key to the agency's future success will be its expanded ability to enter into new partnership arrangements with Parks Canada employees, the private sector and voluntary organizations. This will result in better services at less cost to taxpayers.

Canada's national parks and national historic sites hold special value for all Canadians. Parks Canada's mandate to maintain these nationally significant natural and cultural resources will be maintained and reinforced. Parks Canada will, in line with government priorities, pursue the completion of the system of national parks.

Canada Revenue Commission

Over the course of the last two years, the government has integrated sales, income and excise tax collection, as well as customs and trade administration, into a single consolidated Revenue Canada. This department has made significant strides in improving the effectiveness and efficiency of Canada's revenue administration. By

becoming more client-centred, and through its re-engineering initiative, Revenue Canada is reducing administrative costs and the burden of compliance.

The government would like to take the next step to further improve the cost effectiveness and delivery of this essential government service by establishing a Canada Revenue Commission. This commission would carry on the existing activities of the department but would have considerably more administrative and financial flexibility that would enable it to be more efficient and more responsive to taxpayers.

The creation of the Canada Revenue Commission would also facilitate the development of a closer partnership with provinces in revenue administration, as proposed in the speech from the Throne.

Currently there is substantial overlap and duplication in tax administration between federal and provincial governments. This means that taxpayers are often required to cope with multiple sets of tax rules and tax returns, and to deal with at least two revenue administrations, each with its own operational requirements. This can be complicated and confusing.

Private sector studies have suggested that in the area of sales taxes alone the costs of increased burden on businesses and taxpayers of having to deal with duplicate regimes could be as high as $400 million annually. A federal/provincial approach is key to better servicing taxpayers and achieving greater administrative efficiencies. The government is committed to reducing overlap and duplication in revenue administration. Therefore, the government is proposing to discuss with the provinces the implications of their participation in the proposed Canada Revenue Commission.

Revenue Measures: Tightening Tax Preferences and Ensuring Fairness

In addition to actions to reduce expenditures, this budget announces a number of revenue actions designed to improve the operation of the tax system. For details on these measures, see Annex 5 "Tax Measures Supplementary Expenditures and Notice of Ways and Means Motions".

Reducing special incentives for LSVCCs

Labour-sponsored venture capital corporations (LSVCCs) are funds sponsored by labour organizations to help improve access to capital for small- and medium-sized enterprises. Existing federal and provincial tax credits have helped LSVCCs attract very large amounts of venture capital. Indeed, at the current rate of investment, venture capitalists have more than a three-year supply of capital. Consequently, the budget is proposing:

- a reduction in the tax credit from 20 per cent to a maximum of 15 per cent for shares acquired after budget day-minus-one;
- a reduction in the maximum share purchase eligible for the federal credit from $5,000 to $3,500 starting budget day;
- an increase from five years to eight years of the minimum holding period for shares of federally registered LSVCCs acquired after budget day-minus-one; and
- ineligibility for the federal LSVCC credit for three years following the redemption of an LSVCC share.

Tax-assisted retirement saving

The government provides significant tax assistance to ensure that Canadians make their own investments for retirement. This program is effective and the government is firmly committed to it. Nevertheless, the budget proposes a number of changes to the tax-assisted retirement savings program that will better target the tax assistance to modest- and middle-income Canadians. The changes will make the program fairer to lower-income and younger Canadians, while limiting the cost to taxpayers.

Indefinite carry-forward of RRSP room

To increase flexibility for individuals saving for retirement, the budget proposes to eliminate the seven-year limit on the carry-forward of unused RRSP room. This measure recognizes that many taxpayers may go through lengthy periods – such as early in their careers or when they are raising children – when they are unable to set significant amounts aside for retirement. This measure will make the tax assistance system fairer and more effective by increasing the ability of individuals to make up for low savings levels in earlier years.

Reduced RRSP and money purchase pension plan limits

The budget proposes to freeze the dollar limit on registered retirement savings plans (RRSPs) at $13,500 through 2003, and then increase it to $14,500 in 2004 and to $15,500 in 2005. When the phase-in is complete, this limit will provide full tax assistance on earnings up to about twice the average wage. Contribution limits for money purchase pension plans will be reduced to equivalent levels. The maximum pension limit for defined benefit registered pension plans will be frozen at its current level of $1,722 per year of service through 2004. The more generous carry-forward provisions will help individuals save adequate amounts for retirement within somewhat lower annual contribution limits.

Lower age limit for contributions and withdrawals

The current age limit of 71 for maturing RPPs and RRSPs provides more withdrawal flexibility and tax deferral opportunities than are required given the age at which Canadians are retiring. Accordingly, the budget proposes to reduce the age limit for contributing to RPPs and RRSPs from 71 to 69. Individuals must begin drawing on their pensions and RRSPs by the end of the year in which they turn 69. This will limit the use of RRSPs for unnecessary tax deferrals, and better target them to their intended purpose of providing retirement income.

Non-deductibility of administration fees

At present, administration fees for RRSPs and RRIFs are deductible if paid outside the plan. Since other RRSP investment expenses are not deductible outside the plan, and since these plans already provide significant tax assistance, the budget proposes to eliminate the deduction for administration fees paid outside the plan.

Taxation of non-resident pension recipients on world-wide income

Under current rules, non-residents with Canadian pension income can elect to file a Canadian tax return where their tax liability will be lower than the withholding tax rate. Since hitherto they have only reported Canadian-source income on this return, those with other income get a tax benefit unavailable to Canadian residents. The budget proposes to eliminate this tax advantage for non-residents with Canadian pensions by taxing these pensions based

on world-wide income. This measure is consistent with the treatment of OAS benefits for non-residents introduced in last year's budget. Some other countries, however, do not provide the same options for relief for pension or social security benefits received by Canadian residents. Where this is the case, the government is prepared to work with foreign tax authorities to ensure fair taxation of all pension recipients.

Strengthening the strategy to combat the underground economy

Responsible enforcement programs that fully respect the rights of taxpayers are essential to maintaining the integrity of the tax system. Revenue Canada has put in place in recent years a comprehensive *Underground Economy Strategy* aimed at improving compliance in high risk sectors. Benefits have been significant both in terms of additional revenue made available to preserve public programs, and of fairness to other taxpayers who have always complied with their obligations.

To build on this success, the budget proposes to devote more resources to Revenue Canada's audit program for unincorporated businesses and self-employed individuals, in order to increase the audit coverage rate for these groups. It is expected that the additional revenues generated will be about three times the costs involved.

Update of other initiatives to tighten corporate tax preferences

This budget provides an update (see Annex 5) on three other areas of corporate tax: the results of a review of the Scientific Research and Experimental Development (SR&ED) tax credit claims in the area of Information Technology announced in the 1995 budget; increased reporting requirements for foreign income; and the tightening of the rules for taxation of life insurance companies.

Extension of surcharge on large deposit-taking institutions

This budget announces an extension of the existing temporary 12-per-cent surcharge levied on large deposit-taking institutions for one more year.

Resource sector taxation

The budget announces results of the government's consultations on the resource allowance that were announced in the 1995 budget. This budget clarifies and tightens the resource allowance rules resulting in a more consistent and stable tax structure. The issue of resource sector taxation will be further examined by the Technical Committee on business taxes described in Chapter 5.

The budget also announces relieving changes to the accelerated capital cost allowance rules for new mines, including oil sands mines. It broadens eligibility for accelerated allowances thereby ensuring that different types of oil sands recovery projects are treated more similarly.

The budget proposes to change the existing 60-day rule for flow through shares so that issuing corporations will now have up to one full year to incur eligible expenses. This will facilitate a more efficient and orderly spending of exploration budgets.

The budget also announces a tightening of the eligibility rules for flow-through shares issued by the mining and oil and gas sectors. The budget will terminate the provision for Joint Exploration Corporations.

Level playing field in the energy sector

The 1995 budget announced that the income tax treatment of energy efficiency, renewable energy and non-renewable energy investments would continue to be reviewed. This review is part of work on a baseline study of possible barriers and disincentives to sound environmental practices that was initiated in the 1994 budget.

The budget announces the following income tax changes that will provide an essentially level playing field between certain renewable and non-renewable energy investments:

- extending the use of flow-through share financing which is currently available for non-renewable energy and mining to similar costs for certain renewable energy and energy conservation projects;
- relaxing the "specified energy property" rules to permit corporations in the manufacturing and processing and mining sectors to claim class 43.1 CCA deductions against all income from their business, to assist in the financing of renewable energy investments.

In recognition of the importance of energy efficiency investments in achieving environmental and economic objectives, further analysis and consultation will be undertaken with a view to improving the treatment of investments for energy efficiency and other renewable energy projects.

Environmental trust funds

In the 1994 budget, changes were announced to the income tax rules to permit contributions to qualifying mine reclamation trust funds to be immediately deductible even though reclamation expenses are often incurred only after the mine has ceased operations. This budget proposes further discussions with provinces and industry sectors regarding the income tax treatment of contributions made to trust funds set up for environmentally sensitive purposes such as reforestation and the restoration of waste disposal sites. The objective will be to examine the possibility of extending the existing rules for contributions to qualifying mine reclamation funds to similar funds in other industry sectors.

4

Budget Measures – Securing the Future of Social Programs

Plan for Action

Canada's social programs are among the defining features of this country. Many Canadians are worried about the future of the country's social programs. Two areas of particular concern are the future of Canada's public health care system and the sustainability of the public pension system.

This budget takes action to respond to these concerns. In particular, this budget announces:

- growing funding for the Canada Health and Social Transfer (CHST) under a new five-year arrangement, and a new Health Services Research Fund;
- a new seniors benefit that will replace Old Age Security (OAS) and the Guaranteed Income Supplement (GIS). The new benefit will ensure that support for the elderly will be both fairer and more affordable in the future, while fully protecting today's seniors and near-seniors from any reductions in OAS/GIS payments. Together with changes to the Canada Pension Plan that will result from consultations being undertaken by the federal, provincial governments and territories, these measures will ensure that Canada's public retirement income system continues to provide for all working Canadians as well as today's seniors; and
- a number of tax changes to increase support for children, low-income families, and infirm dependants.

Sustaining the Federal Role in Health and Other Social Programs

Federal/provincial transfers: security, stability and growth

The federal government, in partnership with the provinces, plays a key role in supporting medicare and other social programs. Because of this, all Canadians can expect equal access to public health care, a safety net to support those most in need, the freedom to move throughout the country to seek work, higher education and training available to all who qualify, and reasonably comparable services wherever one lives.

Provinces are responsible for providing health, education and social services in the manner best suited to the particular needs of their own residents. Federal transfers to provinces underpin this network of social programs.

The government is committed to restoring stability and predictability to the funds it transfers to provinces. Long-term funding arrangements for Equalization and Territorial Financing have already been established. This budget completes the task. A new five-year funding arrangement for the Canada Health and Social Transfer will assure provinces of stable, predictable and growing funding to provide Canadians with essential health and social services – now and in the years ahead.

Canada Health and Social Transfer

The 1995 budget launched the Canada Health and Social Transfer (CHST) – a block fund replacing Established Programs Financing and the Canada Assistance Plan – to give provinces enhanced flexibility to design and administer social programs in the most efficient way, and to allocate funds according to their own priorities.

The last budget set funding levels for two years – $26.9 billion for 1996-97 and $25.1 billion for 1997-98. It also announced a provincial allocation for the CHST in 1996-97. Each province will receive the same share of the CHST as it did of the old transfers (Established Programs Financing plus Canada Assistance Plan) in their last year of operation.

These funding levels entailed a reduction in transfers; provinces were asked to share a part of the burden of deficit reduction.

Transfers could not be exempt from restraint, given their size. Cash transfers alone account for almost 23 per cent of federal program spending in 1996-97. Provinces have responded to the challenge. In fact, most expect to reach balanced budgets in 1995-96.

This budget provides secure, stable and growing long-term funding for the CHST that will:

- guarantee growing support for medicare, post-secondary education and social assistance programs;
- restore growth to transfers and meet the government's commitment to stabilize the cash component of CHST;
- provide provinces with more comparable support; and
- legislate stable and predictable funding for provinces.

The government will legislate a five-year CHST funding arrangement covering the years 1998-99 to 2002-03, transferring nearly $130 billion to provinces.

- For 1998-99 and 1999-2000, CHST entitlements (tax points plus cash) will be maintained at the 1997-98 level of $25.1 billion.
- For 2000-01, 2001-02 and 2002-03, entitlements will grow at an increasing pace – 2 per cent less than the growth rate of GDP in the first year, 1½ per cent less in the second and finally 1 per cent less than the growth rate of GDP in 2002-03.

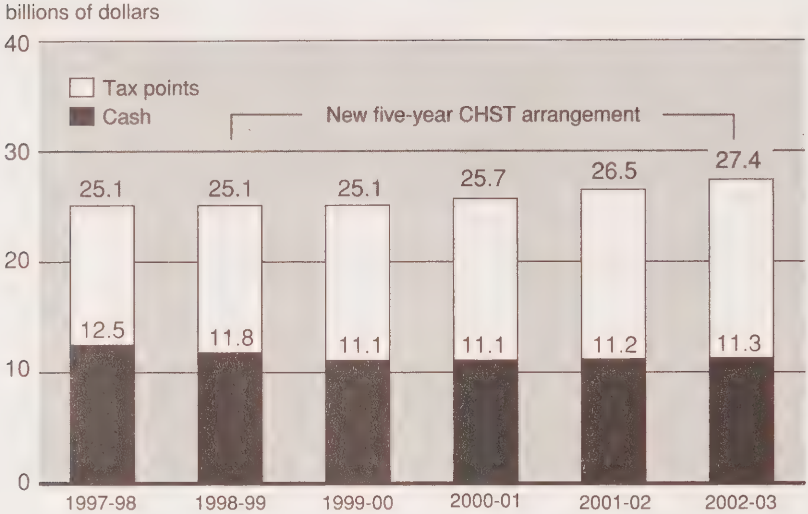
This is the first budget to take action to increase the rate of growth in these transfers since the era of restraint began in the mid-1980s.

Based on current projections, the growth in entitlements will be more than sufficient to stabilize CHST cash. Cash is forecast to be higher than $11 billion at all times over the five-year arrangement and is projected to rise to $11.3 billion by 2002-03.

Growth in the tax component of the CHST may be higher or lower than projected, depending on economic conditions. Should growth in the value of the tax component turn out to be very strong, the cash component of the CHST would be lower than projected, and if it were weak, the cash component would be higher.

To ensure that cash remains a large component of the CHST, an $11 billion cash floor will be legislated. This provides an iron-clad guarantee that cash can never fall below $11 billion throughout the five-year arrangement. The federal cash contribution to health care and other social programs will remain a very large part of the CHST.

Chart 4.1
CHST: Security and stability



Under the five-year CHST arrangement, provinces will receive large and growing federal support for medicare and other social programs. Legislation will provide provinces with stability and predictability. With this new arrangement, the federal government is doing its part to safeguard the social safety net.

Reducing funding disparities

In keeping with the commitment in the 1995 budget, the government has consulted provincial governments on how the CHST could best be allocated among provinces. A new formula for allocating the CHST will be legislated.

The new allocation will reflect migration and other differences in the growth of population among provinces. The new allocation will also gradually narrow existing funding disparities that largely result from the selective limits imposed by the previous government on the Canada Assistance Plan.

For 1997-98 onwards, provincial shares of the CHST will be adjusted to reflect relative population changes among provinces since 1995-96.

Over the five-year arrangement beginning in 1998-99, each province's allocation will be further adjusted to more closely reflect its share of Canada's population. By 2002-03, current disparities in per-capita entitlements among provinces will be reduced by half (Charts 4.2 and 4.3).

Chart 4.2
Provincial shares of CHST in 1995-96

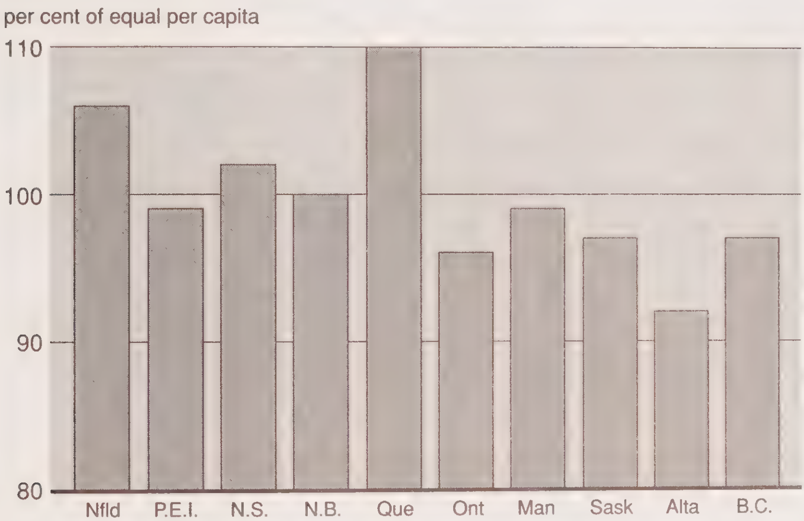
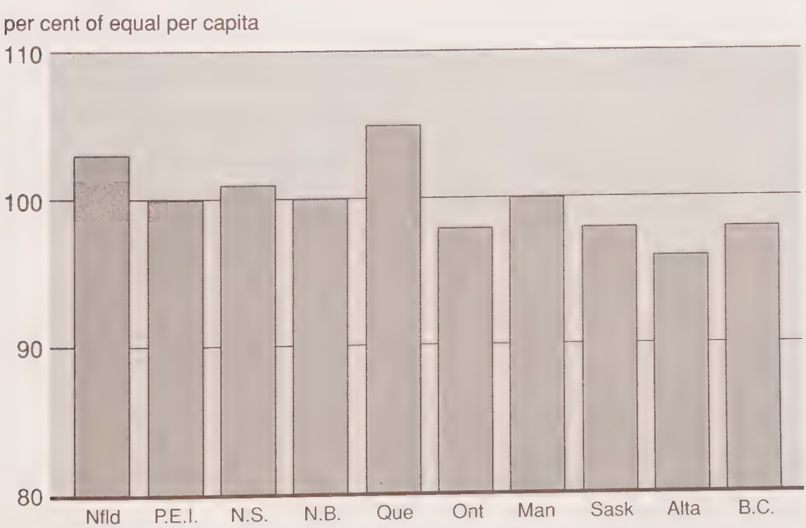


Chart 4.3
Provincial shares of CHST in 2002-03



The phase-in period gives provinces time to adjust to the new allocation and the certainty to undertake long-term fiscal planning.

The new allocation will provide all provinces with more comparable CHST funding to support health and social programs across the country.

The federal government remains willing to examine with provinces further refinements to the allocation that may be appropriate beyond 2002-03. The arrangement may also need to be reviewed if significant changes to federal and provincial roles emerge from future federal-provincial discussions.

Equalization will continue to grow

In addition to the funding provided through the CHST, the federal government makes Equalization payments to provinces to enable them to provide their residents with reasonably comparable levels of public services at reasonably comparable levels of taxation. These payments are totally unconditional – provinces can, and do, use them in support of their highest expenditure priorities, including health and other social services.

Table 4.1
Equalization (estimates)

	1996-97	
	(millions of dollars)	(dollars per capita)
Newfoundland	967	1,684
Prince Edward Island	196	1,430
Nova Scotia	1,148	1,218
New Brunswick	932	1,223
Quebec	4,075	553
Manitoba	1,055	924
Saskatchewan	423	415
	Total 8,796	Average 736

Equalization is the most important federal program for reducing the differences in provincial governments' abilities to raise revenues. In practical terms, Equalization assures that, with average tax effort, all provinces have revenues of $5,000 per resident for funding public services.

In the current five-year Equalization arrangement, transfers are projected to grow from $8.5 billion to $9.6 billion from 1994-95 to 1998-99.

The federal government provides Yukon and the Northwest Territories with funds under Territorial Formula Financing for the provision of public services. In 1996-97 this support will total over $1.1 billion.

Looking ahead: a new partnership

This budget builds on that of 1995 by providing a sustainable and growing five-year funding arrangement for the CHST. The combined actions of the two budgets will:

- allow provinces to design more innovative social programs that respond to the needs of Canadians;
- uphold the principles of the *Canada Health Act* and safeguard freedom of movement for Canadians by assuring access to social assistance without minimum residency requirements;
- help to make Canada's medicare and other social programs financially sustainable, by committing the federal government to predictable and growing funding over five years; and
- provide greater comparability in funding for health and social programs across the country.

This government is responding positively to the needs of provinces and Canadians. This is an important step in building a stronger and more durable social and economic union through a new partnership with provinces and the citizens of Canada.

Table 4.2
Major transfer entitlements to provinces

	1996-97	1997-98	1998-99
		(millions of dollars)	
Canada Health and Social Transfer (CHST)	26,900	25,100	25,100
Equalization	8,796	9,161	9,567
Territorial Formula Financing	1,129	1,105	1,084
Total Major Transfer Entitlements[1]	35,998	34,435	34,776
Tax point transfers	11,853	12,612	13,274
Cash transfers	24,972	22,754	22,476
Total[1]	35,998	34,435	34,776

[1] Equalization associated with CHST tax points appears in both Equalization and CHST entitlements. It has been subtracted from totals to avoid double counting.

Improving Canada's health care system

In addition to restoring growth to the CHST, the federal government has established a constructive partnership with provinces and territories to help sustain and improve Canada's publicly-financed national health care system.

There are serious challenges to the sustainability of Canada's public health care system, including increasing costs in certain key areas such as pharmaceuticals and the changing health needs of Canadians.

A national effort is needed to meet these challenges and to find a balanced response to supply and demand pressures. This involves a greater focus on disease prevention and health promotion activities. The *National Forum on Health* was established to examine some of these issues, and to contribute to the development of a vision of the health system that will meet the health needs of Canadians into the 21st century.

Health Services Research Fund

The federal and provincial governments have been discussing how research can contribute to the renewal of Canada's health care system. To assist these efforts, the Government of Canada will provide funds to help establish a *Health Services Research Fund*. The immediate objective is to bring together partners – from

provincial governments, health institutions and the private sector – who are interested in building a shared fund, thereby making better use of the human and financial resources in the health care system. The research will be practical in nature. It will identify what works in Canada's health care system, what does not work, and what procedures and interventions require further evaluation. By jointly setting priorities and pooling efforts, the results of the research should be more readily and widely adopted to the benefit of all Canadians.

For its part, the federal government will provide $65 million over five years, irrespective of contributions from other partners, of which $15 million will come from reallocation within the Medical Research Council and Health Canada. This contribution will serve two purposes: to help get research underway during the course of the five years, and to help endow the fund so it can continue on an on-going basis after the five-year period, if it proves its merit.

The Minister of Health will consult with provincial and territorial counterparts and other interested partners, on how to set up and manage this fund so that it belongs to all its partners. The Medical Research Council of Canada will administer the fund on behalf of the partners.

Making the Retirement Income System More Sustainable

Canada's retirement income system has served seniors well. Incomes of seniors have grown rapidly over the last three to four decades – indeed, they have grown faster in recent years than the incomes of the working-age population.

Canadians have, however, become worried that the retirement income system will be unsustainable in the future when the baby boom generation starts to retire and costs escalate dramatically.

The government wants to put an end to this insecurity.

Canada Pension Plan

The Canada Pension Plan is a key pillar of the public pension system. It ensures that all Canadians save throughout their working lives toward their retirement. It is a compulsory plan, paid for by the contributions of working Canadians and their employers.

It is, however, essentially a pay-as-you-go system in which contributions each year are used to pay for benefits that year.

Unless changes are made to the CPP, today's younger Canadians and future generations will be asked to pay almost three times more than people are paying now for the same CPP pensions. Steps should be taken now to ensure that future generations are not faced with unreasonable burdens, and to assure young Canadians that the CPP will be there for them when they retire.

The governments of Canada, the provinces and the territories have released an information paper on the Canada Pension Plan. It will form the basis of public consultations on the CPP to be held across Canada, beginning in March.

The federal government and provinces will be working to have solutions to the CPP problems in place by the end of 1996.

A new Seniors Benefit

Federal public pension benefits – Old Age Security (OAS), Guaranteed Income Supplement (GIS), and the Spouse's Allowance (SPA) – make up the other pillar of the public pension system. These programs are funded from general government revenues and amounted to about $20 billion in 1995-96 (after-tax-basis). These benefits are especially important for lower-income seniors. The costs of OAS/GIS pensions will increase substantially in future years. It is imperative that these cost problems be addressed, in order to ensure that the programs will remain sustainable and affordable over the coming decades.

The 1995 budget recognized this problem, and announced the government's intention to release a paper on the changes required to OAS and GIS to ensure these programs remain affordable. It also announced five principles that would guide any change to these programs:

- undiminished protection for seniors who are less well off;
- a continuation of full indexation of benefits;
- provision of OAS on the basis of the combined income of spouses (as is currently the case under GIS);
- greater progressivity of benefits by family income level; and
- control of program costs.

A paper released with this budget[1] proposes to replace OAS and GIS with a new Seniors Benefit that follows the five principles laid out in the 1995 budget. It will be completely tax free and will incorporate the existing age and pension income tax credits. It will begin in 2001.

The key features of the proposed new Seniors Benefit are:

- the new benefit will be implemented in a manner that meets the government's commitment to today's seniors that their OAS and GIS payments will not be reduced and broadens this commitment to apply to everyone age 60 and over as of December 31, 1995;
- under the Seniors Benefit, the vast majority of seniors will be as well or better off – 75 per cent of single seniors and elderly couples will receive the same or higher benefits. Nine out of 10 single elderly women will be better off;
- those most in need will be protected: GIS recipients will receive an additional $120 a year;
- the benefit levels and threshold will be fully indexed to inflation. This is an improvement over the current system where the thresholds are not fully indexed;
- for couples, the amount of the payment will be determined on the basis of the combined income of spouses, as is the case now with the GIS;
- benefits will be delivered in a single monthly payment, which for couples will be made in separate and equal cheques to each spouse; and
- the Spouse's Allowance Program will remain in place and payments will be increased by $120 per year.

The proposed new benefit will create a fairer and more targeted system of assistance for seniors. The Seniors Benefit will also slow the growth in costs of public pensions by reducing benefits for high-income seniors. This represents a major step forward in making the public pension system more financially sustainable and preserving benefits for future generations of seniors.

[1] The Seniors Benefit: Securing the Future.

Giving seniors a choice

Canadians who have currently reached, or are approaching age 65, have limited opportunity to make adjustments in their financial affairs. The new benefit will be implemented in 2001 to provide substantial notice before any changes take effect.

In addition, all Canadians who reached age 60 by December 31, 1995 (i.e. who qualify for OAS/GIS on December 31, 2000) will have the choice of moving to the new system or keeping their monthly OAS/GIS payments for the rest of their lives. (These payments will continue to be fully indexed. OAS payments will continue to be taxable and subject to the current high-income recovery but the age and pension income credits will no longer provide tax savings.)

This means that every current senior and those now over the age of 60 will receive, at the very least, the same OAS/GIS payment. If the new system turns out to be better for them, they will be able to choose the new system. Individuals who are under 60 but married to a spouse now 60 or over will also be able to choose to remain under the OAS/GIS program. Seniors may also opt into the Seniors Benefit at any time after 2001.

This transitional provision ensures that the new system respects the government's commitment to preserve OAS/GIS payments for today's seniors.

Other changes

Recent immigrants' access to the Old Age Security system

To qualify for a full Old Age Security pension at age 65, a person must reside in Canada for 40 years after reaching age 18. Persons with less than 40 years of residence qualify for a partial OAS pension, calculated at the rate of 1/40th of the full pension for each year of Canadian residence. Except for persons from countries with which Canada has a social security agreement, a minimum of 10 years of residence is required to receive a partial OAS pension.

Many immigrants from countries with which Canada has a social security agreement can qualify for full public pensions – Old Age Security, Guaranteed Income Supplement, and Spouse's Allowance – after as little as one year's residence in Canada. This occurs because the very small OAS pension that a person is entitled

to after a short period of residence in Canada automatically qualifies the person for the Guaranteed Income Supplement and their spouse for the Spouse's Allowance, if the person (or couple) has low personal income.

The maximum benefit is currently $864 per month for a single person and $1,401 for a married couple. Most older immigrants coming to Canada are allowed entry only because they have been sponsored by family members who undertake to provide for all their needs. Many, nonetheless, apply for and obtain public pensions after very short periods of residence in Canada.

Nearly $90 million a year is currently paid out in Guaranteed Income Supplement and Spouse's Allowance benefits to persons who had less than 10 years' residence in Canada at the time of application. An estimated two-thirds of these expenditures are for sponsored immigrants.

To ameliorate this situation, the government is proposing two measures:

- Persons with less than 10 years' residence in Canada who qualify for benefits only through social security agreements with Canada will be able to qualify for, at most, 1/10th of the Guaranteed Income Supplement or the Spouse's Allowance for each year of residence in Canada. These are mostly recent immigrants. Over the course of 10 years, they will gradually become entitled to full benefits under the *Old Age Security Act*. Newcomers from countries without social security agreements with Canada will still be required to complete 10 years' residence before qualifying for any benefits.

- Sponsored immigrants from countries which have social security agreements with Canada will not be eligible for the Guaranteed Income Supplement or Spouse's Allowance for the period of sponsorship – up to 10 years. They will otherwise be treated as above, as will exceptional cases where sponsors cannot meet their commitments – for example, in the case of the sponsor's death or elder abuse. (Sponsored immigrants from countries with which Canada has a social security agreement will still be eligible for Old Age Security benefits on the same terms as other Canadian residents – 1/40th of the full Old Age Security benefit for each year's residence in Canada prior to applying for OAS.)

Both changes will apply immediately to newcomers landing in Canada after budget day. For all other newcomers who have already landed in Canada as of budget day, the existing rules will apply until

December 31, 2000, thereby giving a period of notice. Persons not eligible for benefits under the *Old Age Security Act* by that time will be subject to the new provisions.

Persons already receiving benefits will be unaffected.

These proposals would provide no savings in 1996-97. Savings would grow to an estimated $100 million after 15 years.

Support for Families and Charities

As promised in the 1994 budget, the government is moving ahead with improvements to the child support system in Canada. The government is putting forward a paper[2], included with the budget documents, that outlines a package of child support reforms. These include a change in the tax treatment of child support, the introduction of guidelines for child support award levels, new measures to improve the enforcement of support orders, and a doubling of the Working Income Supplement.

New tax treatment of child support

The government proposes that child support paid pursuant to an agreement or court order made on or after May 1, 1997 not be included in the income of the recipient for tax purposes, nor be deductible to the payer. Child support paid pursuant to an agreement or court order made before May 1, 1997 will be included in the income of the recipient and will continue to be deductible to the payer, unless and until the child support award is revised. Procedures will be introduced to make it easier for parents with existing agreements to change to the new regime. These parents will be allowed to file a joint election with Revenue Canada to apply the new tax treatment.

Increase the Working Income Supplement

Child benefits for low-income families will be enriched through a two-step doubling of the Working Income Supplement (WIS) under the Child Tax Benefit. The WIS is designed to help low-income parents meet some of the extra costs related to participation in the paid labour force, such as transportation to work and child care expenses. Also, the WIS helps make up for the loss of benefits such

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[2] *The New Child Support Package.*

as dental care and free drug prescriptions for parents who leave social assistance and re-enter the labour force. The government proposes to increase the maximum annual benefit from $500 to $750 in July 1997, and to $1,000 in July 1998. When fully phased-in, the WIS will provide an additional $250 million annually to an estimated 700,000 low-income working families, one-third of which are single-parent families.

The implications of these new child support measures are more fully described in the child support document.

Child care expense deduction for older children

The current age limit of 14 for children with respect to whom the child care expense deduction may be claimed does not recognize the needs of some parents, especially single parents, who work at jobs requiring them to be away from home at night. Accordingly, the government proposes to raise the age limit for eligible children to 16. This measure will complement other changes to the child care expense deduction, outlined in Chapter 5, that will assist single parents and support learning.

Enhancing support for the vulnerable

Increased assistance for care of infirm dependants

Many Canadians provide support and care to adult children and other relatives with moderate to severe medical conditions. To provide additional tax relief to these individuals, the government proposes to increase the value of the infirm dependant credit from $270 to $400 and to raise the dependant's net income threshold for the phase-out of benefits from $2,690 to $4,103.

Increased incentives for charitable donations

As the role of government evolves in keeping with fiscal circumstances, the charitable sector is playing an increasingly important role in Canadian society.

The government recognizes that it is in the interest of all Canadians that the charitable sector have the ability to raise sufficient funds to fulfill that expanding role.

The pre-budget consultation process elicited several innovative suggestions as to how this goal might best be achieved.

The government is acting in this budget to implement the recommendation of the House of Commons Standing Committee on Finance and of the Canada Council that the annual limit on charitable donations be increased from 20 per cent of net income to 50 per cent.

In addition, that limit will be increased to 100 per cent for testamentary gifts in order to encourage charitable bequests. Finally, in order to prevent taxpayers who make gifts in forms other than cash from facing a cash-flow impact, the 50-per-cent limit will be further increased by 50 per cent of the taxable capital gain resulting from the donation of appreciated capital property.

But more may need to be done.

In the coming year, the Department of Finance will examine ways of further encouraging charitable giving and charitable activities, particularly in areas where, due to the fiscal situation of governments, individuals and communities are being asked to do more.

Ways of ensuring that increased government support to charities is effectively translated into activities of direct benefit to Canadian society will be examined.

The department will consult with the charitable sector during the course of this work.

5

Budget Measures – Investing in the Future

Plan for Action

The most important investment that can be made in Canada's economic future is a healthy fiscal situation. This is addressed in Chapter 2.

But other actions can also be taken to help to foster the creation of jobs and growth. In this budget, the government is taking a number of initiatives, through spending and tax expenditure reallocations, to increase Canada's investment in three key areas:

- education and employment opportunities for young Canadians;
- technology and innovation; and
- international trade.

These initiatives were identified in the work of the Jobs and Growth Committee of Cabinet. As explained in Chapter 1, they are being undertaken through reallocations of resources from lower priority areas.

Encouraging Education and Skills

Attaining higher levels of education and skills is critical to the ability of Canadians to secure their own and Canada's future. As indicated in Chapter 4, the budget provides secure, long-term funding for transfers to provincial governments, which go in part to support post-secondary education.

The learning package

In this budget, the government is providing an additional $80 million a year in tax assistance to help students and their families deal with the increased costs of education. This will be funded through reallocations within the tax system.

Students currently receive assistance with their costs under two tax provisions – the tuition fee credit and the education credit. As tuition fees rise, the amount of assistance provided by the tuition fee credit increases automatically.

In this budget:

- The amount on which the education credit is based is increased from $80 to $100 per month.
- The limit on the transfer of tuition and educational amounts is increased from $4,000 per year to $5,000.
- The annual limit on registered education savings plans (RESP) contributions is increased from $1,500 to $2,000 and the lifetime limit is raised from $31,500 to $42,000.
- The eligibility for the child care expense deduction (CCED) is broadened by allowing single parents who are in full-time attendance at school to claim the CCED against all types of income. This measure will also apply to two-parent families when both are full-time students. As well, parents who are completing high school will be allowed this deduction for the first time.

In addition to these measures, as indicated earlier in Chapter 4, the child care expense deduction will be further expanded by increasing the age limit to assist parents of older children.

Canada Student Loans

Under the Canada Student Loans Program, the government supports more than $1 billion in new student loans each year to help students obtain financing to advance their education at post-secondary educational institutions. On August 1, 1995, the government made a series of major reforms to the Canada Student Loans Program to provide more assistance to students who most need it, while making the program more efficient and cost-effective.

Students benefit from increased loan ceilings, special grants for groups such as disabled persons and high-need students, and expanded interest relief for borrowers encountering difficulty in

repaying their loans. The efficiency of the program has been improved through new arrangements with Canadian financial institutions. The lenders will take on the risk and costs of borrowers defaulting on their loans.

Changes will be made to the *Canada Student Loans Act* to provide the lenders more flexibility to extend repayment terms in order to meet the changing needs of student borrowers. This should reduce defaults.

Promoting Youth Employment

While employment is of concern to all Canadians, young people are finding it particularly difficult to find and sustain jobs. Education and skills, while necessary, are no longer always sufficient in themselves to guarantee employment in today's changing job market.

In addition to the initiatives being taken to increase assistance for education outlined above, the government is reallocating $315 million of budget savings to help create employment opportunities for young Canadians over the next three years.

Summer employment

The costs of post-secondary education and the skill requirements of today's job market increase the importance of student summer employment. This provides an opportunity for students to earn money to complete their education, as well as obtain critical job experience.

Some of the reallocated funds for youth initiatives will be used to double, to $120 million in 1996-97, the assistance the government provides for student summer employment placements.

Transition from school to work

As explained in Chapter 2, young Canadians face particular difficulties making the transition from school to the job market. The unemployment rate of Canadians under the age of 25 is about 16 per cent, over one and a half times the national average. The problem is particularly acute for those with only some high school or a high school diploma.

Most of the remaining funds reallocated to promoting youth employment are being directed to assist young people who have left school to find employment opportunities. It will be in addition to existing funding of about $160 million annually for Youth Internship Canada and Youth Service Canada.

Many of these initiatives will be targeted to those with lower levels of education in recognition of the particular difficulties they face in accessing the labour market. They will also focus on providing employment opportunities in new and emerging sectors of the economy such as information technologies, biotechnology, environmental industries, tourism, culture, parts of the services industry and in international trade and development.

Encouraging Technology and Innovation

In the last budget, the government took action to substantially reduce subsidies to business. At the same time, it indicated that its remaining industrial assistance would focus on the key engines of economic growth – trade development, science and technology and small- and medium-sized business.

The 1995 budget also emphasized that future science and technology efforts would be concentrated more strategically on activities that foster innovation, rapid commercialization and value-added production. It also recognized that some Canadian companies are faced with foreign competitors who are strongly backed by their governments.

The link between technology, jobs and growth

Innovation is the driving force behind improved productivity, and is thus central to economic growth and long-term job creation. Technological innovation provides the opportunities which are key to developing new products and new markets in the economy of today and tomorrow.

Economies with high levels of successful innovation attract investors, and provide the conditions for strong productivity growth. This enables incomes to increase, opening new market opportunities and helping to preserve and expand market share both at home and abroad. This is a dynamic renewal process which stimulates the demand for goods and services, and generates new job opportunities. Fostering technology and innovation is important

not only to the emergence of high technology industries, but also to the efficiency and competitiveness of traditional Canadian industries, such as agriculture and food, forest products, and other resource-based sectors.

In order to help the economy innovate and deal with technological change, the government is reallocating an additional $270 million from budget savings to encourage technology and innovation over the next three years.

Technology development

Technology Partnerships Canada will lever investment in high technology products and processes and facilitate their commercialization. It will operate on the basis of partnerships and risk sharing with the private sector. The reallocated resources provided in this budget, together with existing Industry Canada resources, will enable this program to grow from about $150 million in 1996-97 to about $250 million by 1998-99.

This support will help maintain jobs in the aerospace sector, which faces particularly heavily subsidized foreign competition, and assist defence conversion. It will also encourage the development of environmental technologies, as well as the emergence of new "enabling technologies" such as advanced manufacturing and materials technologies and biotechnology.

Technology Partnerships Canada will be part of a broader government-wide technology effort which also involves programs to promote the diffusion of technology within the economy, such as the soon-to-be-launched Canadian Technology Network, as well as other technology-based programs provided by other government departments and agencies.

The program will supplement federal tax incentives for SR&ED to assist the private sector in developing new products and processes, improving productivity, enhancing competitiveness and growth and creating jobs for the benefit of all Canadians.

Access to technology for youth and communities

Canadians, especially young Canadians, recognize that new and emerging technologies are key to their ability to secure and sustain employment in today's economy.

In 1994, the government introduced SchoolNet, a $52 million initiative carried out in co-operation with federal, provincial and territorial governments, the educational community and the private sector aimed at linking Canada's 16,000 schools and 3,400 public libraries to the information highway, and helping teachers, students and communities take advantage of national and international information and education resources. The Community Access component of SchoolNet is a high-impact, low-cost initiative aimed at helping 1,000 rural communities prepare for and participate in the new knowledge-based economy.

As part of the government's youth and technology initiatives, about $30 million is being reallocated over three years to expand this program.

- These funds will be used to create opportunities for young Canadians in rural and urban areas to work with small businesses and voluntary organizations that have yet to take advantage of the potential of the Internet to decrease costs and expand markets.
- They will also be used to provide opportunities for students and unemployed young people in rural, remote and disadvantaged areas to digitize significant heritage and other collections and display them on the information highway, in partnership with businesses, local organizations and other levels of government.
- Community Access will also be expanded to accelerate its implementation and increase the number of Canadian communities connected to the information highway, in partnership with businesses, educational institutions, and other levels of government.

These initiatives, in part, reflect the government's commitment to the economic renewal of rural Canada. The government will address the problems facing rural Canadians in a way that is tailored to their needs. Rural Canada is rich in natural and human resources and faces different challenges than in urban areas. The government will move forward in the coming months to make sure that all Canadians benefit from economic prosperity.

Framework for the information highway

Information technology and communications infrastructure are key to innovation, growth and productivity. The broadcasting, telecommunications, and computer services industries constitute one of Canada's fastest growing sectors, with a growth rate about twice that of the economy as a whole. The information sector overall employs about half a million Canadians.

Maximizing the contribution of the information highway to jobs and growth requires an integrated policy and regulatory framework which can adapt to rapidly changing information and communications technology and encourage investment. The Ministers of Industry and Canadian Heritage will be introducing policies and reforms to facilitate greater reliance on the marketplace, while at the same time respecting the commitment to affordable access and to Canadian content and culture.

The Minister of Canadian Heritage will be examining ways to more effectively promote the production of Canadian culture by the CBC and private producers.

To accelerate the introduction of new wireless services, steps will be taken to permit auctioning of the radio spectrum, where appropriate, in the future.

Scientific and Research Tax Credit

The current system of income tax incentives for scientific research and experimental development (SR&ED) is widely recognized as providing one of the most favourable investment climates for research and development in the world.

The review of information technology SR&ED, which was announced in the 1995 budget, found that the existing income tax rules can be applied successfully to information technology SR&ED performed by all types of firms, and that any difficulties can be resolved through revisions to the administrative guidelines and enhanced audit coverage.

During 1996 the government will complete an evaluation of the SR&ED tax incentives in terms of their relevance, impacts and effects, and cost-effectiveness.

Business Development Bank (BDC)

The flexibility and lending ability of the Business Development Bank of Canada (formerly the Federal Business Development Bank) have been increased through new legislation and a new mandate in order to better serve small- and medium-sized businesses that cannot get financing from conventional lenders. The Bank is substantially increasing its lending efforts to help businesses in strategic growth sectors, such as new technology.

In this budget, the government is injecting $50 million in equity into the Business Development Bank through a purchase of dividend-paying preferred shares. This equity capital will allow BDC to lend up to an additional $350 million to knowledge-based, exporting and growth businesses that find it difficult to obtain loans from commercial institutions.

Realizing Canada's Trade Potential

The fastest growing segment of the Canadian economy in the 1990s has been the export sector. Real exports of goods and services have grown at an average annual rate of almost 8 per cent per year since 1989. As a result, today, a third of the value of all production in Canada is exported.

Major trade liberalization measures resulting from the Uruguay Trade Round and NAFTA have substantially improved access for Canadian goods and services in foreign markets. Canadian capital and labour are of high quality, and Canadian industry is competitive. Demand is no longer limited to that within Canada's borders; Canada can sell to the world. Yet, most Canadian exports come from a small number of companies, and many Canadian businesses still do not export at all.

Export financing is critical to ensuring more Canadian businesses realize opportunities in foreign markets. In the 1995 budget, the government indicated it was pursuing new and innovative approaches to the area of export sales financing. A subsidiary of Export Development Corporation (EDC), Exinvest, was created to establish risk-sharing partnerships between EDC and Canadian exporters.

In this budget, the government is taking further steps to increase the financing available to Canadian exporters.

- **Additional resources.** The government is making a one-time equity injection of $50 million into EDC to provide the corporation with additional capital for further innovative uses of export financing, such as new export sales financing vehicles and new partnerships with exporters and commercial banks.
- **Greater leverage of existing resources.** The government will also reallocate resources from concessional loans to foreign borrowers and use them to finance higher volumes of nonconcessional loans under an improved system of risk management. This will increase

the volume of financing for Canadian exporters by as much as $500 million annually, leading to further export growth and job creation. The system will require setting aside sufficient provisions to cover the risks of any non-payment. When loans are repaid, provisioning funds will be recycled to use against new loans. The provisioning system will apply to the Canada Account administered by the Export Development Corporation and to the Agri-Food Credit Facility announced in the 1995 budget.

Business Tax Review to Promote Jobs and Growth

Canadians desire a tax system that generates revenue in a fair and simple manner for federal and provincial governments. They also wish to have a tax system that encourages economic growth and the creation of jobs.

Given the complexity of the task, the government is undertaking a review of those aspects of tax law that most affect the creation of jobs. A Technical Committee has been appointed in the Department of Finance that will examine business taxes, including corporate income, capital and payroll taxes, and personal taxes paid on income derived from businesses with the objective of assessing both the level and mix of taxes. The assessment will be conducted with the following objectives:

- improving the tax system to promote job creation and economic growth in an open economy;
- simplifying the tax system with respect to the taxation of business income so that taxpayers will be able to more easily comply with the system and Revenue Canada may more easily administer the system; and
- enhancing fairness in the tax system by ensuring that all businesses share the cost of providing government services.

The report will be released later this year, followed by consultations with the public.

6

The Economic Assumptions

Introduction

The economic environment for budget planning has changed since last year's budget. While a slowdown in the U.S. and Canada was foreseen, it occurred sooner and was more severe than expected by almost all forecasters. The slowing in the U.S. has, however, significantly reduced inflation pressures there, with the result that the Federal Reserve Board has been able to lower interest rates. In Canada, lower U.S. rates and lower inflation pressures, combined with good progress in reducing budget deficits, has given the Bank of Canada an even greater scope for lowering interest rates, which have trended down since early 1995 and closed much of the gap with U.S. short-term interest rates. As a result, both nominal GDP – effectively the tax base – and interest rates are now expected to be substantially lower in 1996 than previously projected. The net impact on the fiscal outlook is small, however highlighting the importance of making prudent economic assumptions for budget planning.

This budget continues the practice of using prudent economic assumptions for fiscal planning. These assumptions are developed by applying a prudence factor to interest rates in the average private sector forecast and allowing the impacts to flow through to output and inflation. This emphasis on using prudent economic assumptions does not mean that the government is pessimistic about Canada's economic prospects. But the importance of meeting deficit reduction targets means that the government must use prudent assumptions for fiscal planning. Setting and achieving credible fiscal targets will in turn contribute to good economic performance.

Recent Developments in Canada

Growth and employment

After rising 4.6 per cent in 1994, real GDP increased 2.2 per cent in 1995. The slowdown reflected international and domestic developments. Export growth decelerated dramatically during 1995 as growth in the U.S. economy, particularly the automotive and housing sectors, slowed. Final domestic demand inched ahead about 0.7 per cent, down from 2.9 per cent growth in 1994, as high real interest rates solicited uncertainty and fragile confidence restrained household spending.

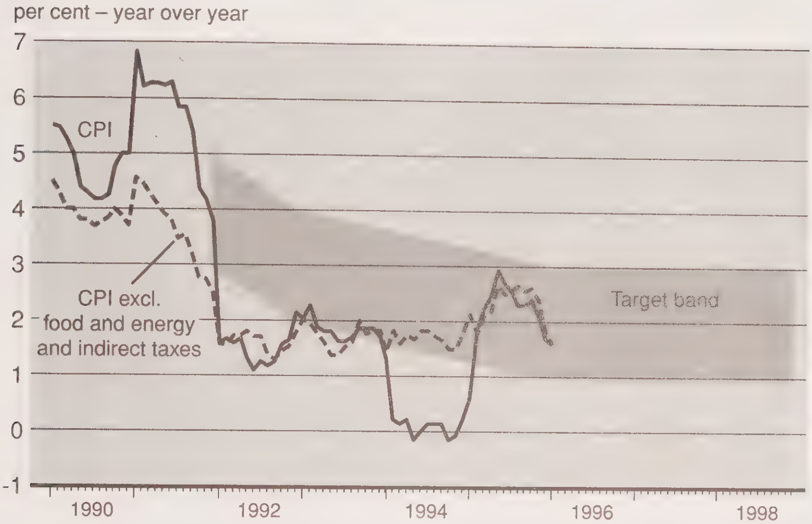
Employment growth also slowed relative to 1994, in part due to needed cutbacks in the public sector as governments at all levels dealt with their fiscal problems. Since the end of 1994, private sector employment rose 263,000 while public sector employment *fell* 120,000.

Recent economic developments are, on balance, more encouraging. While housing starts and spending on cars declined early in the year, housing resales surged more than 20 per cent in January. Manufacturing shipments also showed some strength at the end of 1995. Most importantly, employment rose 93,000 from November to January as an increase of 123,000 private sector jobs was partially offset by declining public sector employment. An improving labour market will raise household income and bolster consumer confidence.

Prices and costs

As expected, the CPI inflation rate has fallen sharply from its peak in mid-1995. The level of the CPI has been almost unchanged since May, pushing the 12-month inflation rate down from 2.9 per cent to 1.6 per cent in January. In assessing inflation pressures, the Bank of Canada monitors the core (excluding food and energy) CPI, net of indirect taxes. This measure of inflation has also fallen sharply and is now below the mid-point of the 1 to 3 per cent target band (Chart 6.1).

Chart 6.1
Consumer Price Index and Net Price Index



This excellent inflation performance reflects solid productivity growth and the virtual absence of cost pressures. Since 1991, labour productivity has risen at an annual rate of 1.2 per cent while wage rates have increased about 1¼ per cent a year, keeping unit labour costs more or less stable over the period.

Canada's trade performance

Restrained wage growth, good productivity performance and the depreciation of the dollar since 1991 have improved Canada's competitive position dramatically. While economy-wide unit labour costs in Canada have been stable since 1991, they have risen approximately 10 per cent in the U.S. Expressed in common currency, Canada's unit labour costs are near their lowest level relative to the U.S. in the 45 years that records have been kept. The improvement relative to other countries is even more striking: from 1991 to 1994, Canada's labour cost position in manufacturing improved almost one-third relative to the overseas G-7 countries. As a result, the merchandise trade surplus has soared (Chart 6.2), helping to push the current account deficit to a 10-year low as a share of GDP (Chart 6.3).

Chart 6.2
Merchandise trade surplus

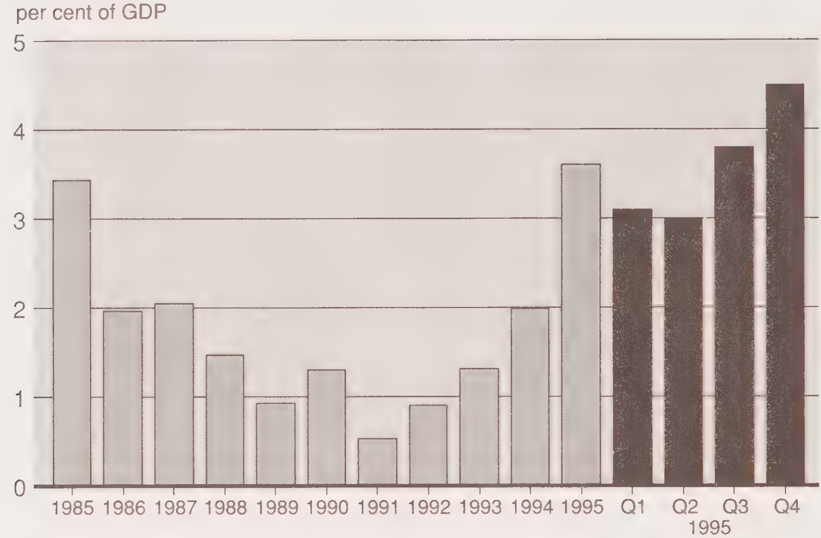
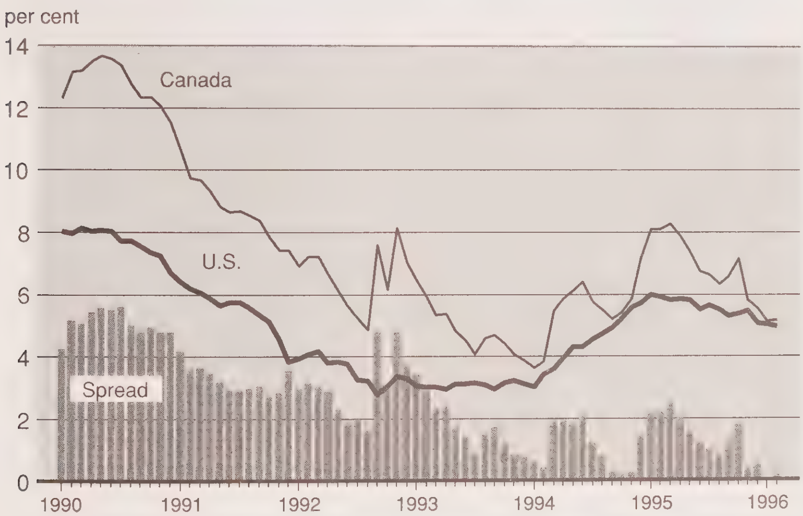


Chart 6.3
Canada's current account balance

Interest rates

Investor sentiment regarding Canada is improving, reflecting low inflation, excellent trade performance and tangible results reducing deficits by the federal and provincial governments. This more favourable sentiment has allowed the dollar to strengthen and Canada-U.S. short-term interest rate differentials to fall from a peak of almost 250 basis points in March 1995 to about 20 basis points in late February (Chart 6.4). The rate on 3-month Treasury bills was 5.2 per cent in late February, down about 300 basis points from its peak in March 1995. One-year mortgage interest rates have fallen 350 basis points, to 6.5 per cent, since early 1995.

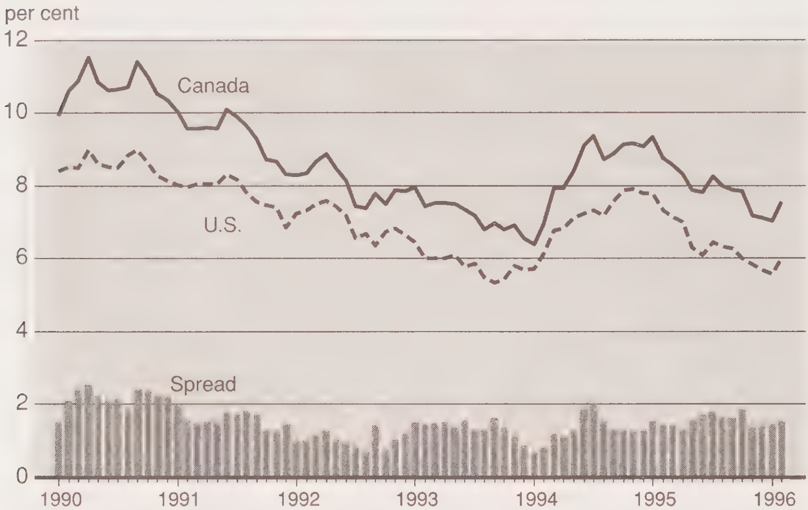
Chart 6.4
3-month Treasury bills



Long-term interest rates, which provide an excellent barometer of overall investor sentiment, have also fallen sharply since early 1995. The rate on 10-year government bonds was around 7½ per cent in late February, down more than 200 basis points from its peak in January 1995 (Chart 6.5). Most of the decline, however, is due to lower U.S. long rates: in late February, the differential was about 150 basis points, down only slightly from its value in early 1995. This indicates long-term interest rates can come down substantially if persistent worries about fiscal sustainability and political uncertainty can be addressed and indeed eliminated.

Chart 6.5

10-year government bond



The External Environment

Major overseas economies

Growth in the overseas industrial economies in 1995 was weaker than expected in last year's budget. Japan experienced its fourth consecutive year of little growth. The major European economies generally started 1995 with strong growth, but weakened through the year. The short-term outlook is for continued slow growth.

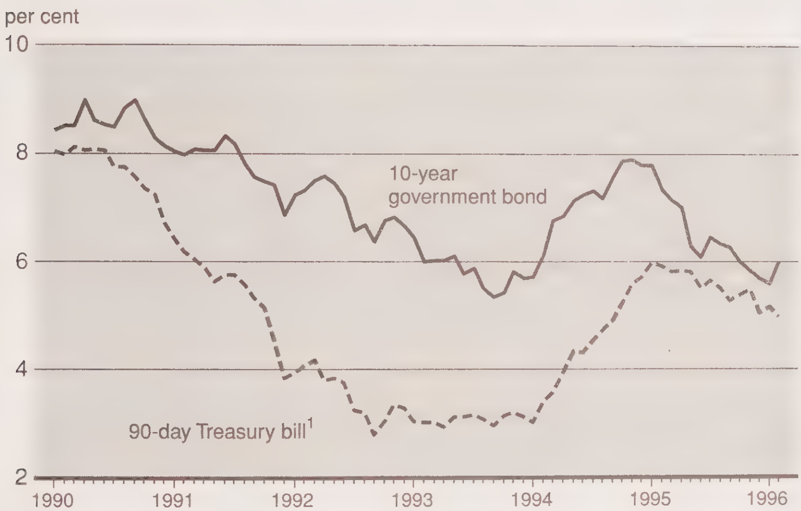
Interest rates have been falling in Europe, and given the current sluggishness in growth and the lack of inflation pressures, there is likely room for further interest rate reductions. By the second half of 1996, growth in Europe should begin to respond to this stimulus. Growth in Japan is also expected to increase in response to the current ease in monetary conditions, the substantial stimulus in recent fiscal packages and the recent decline in the value of the yen. By most estimates, there will continue to be substantial spare capacity in all the major overseas economies this year and next, indicating that inflation should remain low.

The United States

Growth in demand in the U.S. slowed abruptly at the end of 1994 and beginning of 1995, in part at least in response to the rise in interest rates through 1994. The slower pace of economic activity reduced the capacity and incipient inflation pressures that had built up in the economy by the end of 1994. As a result, in 1995 the U.S. economy experienced its fourth consecutive year of inflation of 3.0 per cent or less.

Chart 6.6

U.S. interest rates



[1]True yield basis.

Slower growth and easing inflation pressures have led to significant declines in interest rates, particularly at the long end as investor confidence has improved. While the Federal Reserve has lowered its federal funds rate target only three times over the last year for a total decline of 75 basis points, the 10-year bond rate has fallen around 2 percentage points from its peak in late 1994. As a result, the spread between short-and long-term interest rates is currently somewhat narrow by historical standards.

Most private sector forecasters expect the Federal Reserve to reduce the federal funds rate at least a further 25 basis points in the next several months. This is generally thought sufficient to keep the U.S. growing at about its potential rate through 1996 and 1997, allowing the inflation rate to stabilize near its current level (Table 6.1). Private forecasters expect long-term interest rates to rise slightly from current levels over the rest of this year and next, averaging 5.8 per cent this year and 5.9 per cent in 1997.

Table 6.1
Economic assumptions for the U.S. – private sector average

	1995	1996	1997
Real GDP growth (%)	2.1	2.0	2.1
CPI inflation (%)	2.8	2.7	2.9
90-day Treasury bill rate (true yield) (%)	5.6	5.1	5.1
10-year government bond rate (%)	6.6	5.8	5.9

Source: Blue Chip Economic Indicators February 10, 1996. This is a survey of approximately 50 U.S. private sector forecasters. The 90-day bill rate has been adjusted from a discount basis by the Department of Finance.

There is a spread of about 70-80 basis points between short and long rates in the average private sector forecast. This is unusually small compared to the 10-year average of about 200 basis points. While inflation expectations may have changed and the prospects for further fiscal consolidation have improved the outlook for long-term rates, there is a risk that long rates will rise more than expected, particularly in 1997.

The Economic Assumptions for Canada

Private sector views

The survey of private sector forecasters was completed in mid-February. As a result, private sector views do not reflect the national accounts data for the fourth quarter of 1995, which were published on February 29.

Private forecasters generally expect that lower interest rates and Canada's strong competitive position will result in better economic performance as the year progresses (Table 6.2). While the average level of output in 1996 is forecast to be 1.9 per cent higher than in 1995, growth from the end of 1995 to the end of 1996 is expected to be about 2½ per cent, well above the 0.6 per cent growth throughout 1995. Growth is generally expected to pick up in 1997.

Table 6.2
Economic assumptions for fiscal planning

	1995[1]	1996	1997
Real GDP growth (%)[1]			
Private sector average	2.5	1.9	2.8
Prudent alternative	2.2	1.8	2.6
Nominal GDP growth (%)[1]			
Private sector average	4.3	3.5	4.6
Prudent alternative	4.0	3.3	4.3
Nominal GDP ($ billion)[1]			
Private sector average	782	809	846
Prudent alternative	780	806	841
91-day Treasury bill (%)			
Private sector average	7.0	5.3	5.8
Prudent alternative	7.0	5.8	6.6
10-year benchmark government bond rate (%)			
Private sector average	8.2	7.2	7.4
Prudent alternative	8.2	7.7	8.2

[1] The numbers for the prudent alternative reflect the February 29, 1996 release of the Canadian Income and Expenditure Accounts, whereas the private sector averages do not.

Note: The private sector average is based on 20 respondents for 1996 and 18 for 1997.

Inflation is forecast to remain close to the mid-point of the inflation control target bands over the next two years. As a result, nominal GDP, which is a reasonable proxy for the tax base, rises 3½ per cent this year and about 4½ per cent in 1997.

Private forecasters expect short-term interest rates to average 5.3 per cent this year, while long rates (10-year government bonds) average 7.2 per cent. Interest rates are forecast to rise next year. Forecasters attribute some of this to heightened political uncertainty in Canada which would raise spreads with U.S. short-term rates.

A Prudent Alternative for Fiscal Planning

The use of prudent economic assumptions for fiscal planning was initiated in the February 1994 budget. The economic assumptions underpinning the fiscal plan are developed by adopting a more prudent view on interest rates, and hence overall economic activity, than in the average private sector forecast. This approach has helped restore credibility to the fiscal forecast and, as a result, has helped bring forward the benefits of deficit reduction in the form of lower interest rates.

In its most recent report on budgetary policy, the House of Commons Standing Committee on Finance noted that the economic outlook is even more unpredictable than usual due to continued political uncertainty in Canada and the volatility of international interest rates. These considerations led the Committee to recommend that the economic assumptions underpinning the fiscal plan should be even more prudent than usual, particularly for 1997. Specifically, the Committee recommended that a prudence factor of 50 to 100 basis points be added to the average private sector forecast of interest rates, and that the forecast for nominal GDP reflect the impact of these higher interest rates in slowing growth and lowering inflation.

The interest rate prudence factors for 1996 have been set at 50 basis points. For 1997, however, the Committee's argument for additional prudence is compelling, particularly given that private sector forecasters are not building in much of an interest rate buffer to account for a possible renewal of the unity debate and, perhaps, another referendum. Further, private forecasters may be underestimating the prospects for rising U.S. long-term interest rates. As a result, the government is using prudence factors of 80 basis points in 1997.

These higher interest rates reduce, relative to the private sector average, real growth 0.1 percentage point in 1996 and 0.2 percentage point in 1997. Slower growth results in lower inflation as well. With lower growth rates, and incorporating the actual data for 1995, which Statistics Canada released on February 29, 1996, the 1997 level of nominal GDP is about $5 billion lower than in the private sector average.

Comparison with Previous Economic Assumptions

The evolution of the government's economic assumptions since the February 1995 budget is shown in Table 6.3. The table illustrates a striking change in private sector views over the past year. Real GDP growth in 1995 was much weaker than expected in last year's budget but interest rates turned out to be about 150 basis points lower than assumed. The assumptions for growth and inflation for 1996 have also been marked down substantially since the 1995 budget, reducing the level of nominal GDP by $15 billion. Interest rates are assumed to be about 175 basis points lower than in last year's budget, providing an offset to the impact of lower nominal income on the deficit. The changes since the Fall Update are by themselves quite substantial.

Table 6.3
Evolution of the economic assumptions

	1995[1]	1996	1997
Real GDP growth (%)			
1995 budget	3.8	2.5	n.a.
December update	2.2	2.3	n.a.
1996 budget	2.2	1.8	2.6
Nominal GDP growth (%)			
1995 budget	5.5	4.3	n.a.
December update	4.0	4.1	n.a.
1996 budget	4.0	3.3	4.3
Nominal GDP ($ billion)			
1995 budget	787	821	n.a.
December update	780	812	n.a.
1996 budget	780	806	841
91-day Treasury bill (%)			
1995 budget	8.5	7.5	n.a.
December update	6.9	6.8	n.a.
1996 budget	7.0	5.8	6.6
10-year benchmark government bond rate (%)			
1995 budget	9.7	9.0	n.a.
December update	8.0	8.3	n.a.
1996 budget	8.2	7.7	8.2

[1] 1996 budget assumptions for 1995 are actual data.

7

The Fiscal Outlook

Overview of the Fiscal Outlook to 1997-98

On track for targets

Financial results for the first nine months of 1995-96 indicate that the deficit target of $32.7 billion for 1995-96 will be met, if not bettered. Final deficit results will be published in the *Annual Financial Report* to be released in the fall of 1996.

The fiscal projections for 1996-97 and 1997-98 are based on the prudent economic planning assumptions discussed in Chapter 6. The government is backing up these planning assumptions with substantial contingency reserves – $2.5 billion in 1996-97 and $3.0 billion in 1997-98.

The actions taken in the 1994 and 1995 budgets, coupled with the proposed Employment Insurance (EI) reform measures, ensure that the deficit target of 3 per cent of GDP, or $24.3 billion, for 1996-97 will also be met. If the Contingency Reserve is not needed, it will not be spent. It will go to reducing the deficit further.

The deficit impact of the actions taken in the 1994 and 1995 budgets increases over time. These actions combined with the savings from EI reform ensure that the deficit target of 2 per cent of GDP or $17 billion for 1997-98 will also be met.

Meeting the deficit targets dramatically slows the growth in the debt-to-GDP ratio. The debt-to-GDP ratio will peak in 1996-97 and decline in 1997-98 – the first meaningful decline since 1974-75.

The government's budget strategy is beginning to pay off. This strategy is based on setting two-year rolling deficit targets and ensuring that these targets are met. It involves the use of prudent economic planning assumptions backed by substantial Contingency Reserves.

The Contingency Reserve

The Contingency Reserve is included in the deficit projections primarily to cover risks arising from (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. The Contingency Reserve also provides an extra measure of back-up against adverse errors in the economic forecast. **The Contingency Reserve is not a source of funding for new policy initiatives.**

The budget strategy also involves the control of government spending to ensure that the bulk of deficit reduction comes from spending restraint and that new priorities are met through reallocation of spending.

As a result of this strategy, program spending is set to decline in absolute terms each year from 1992-93 to 1998-99 from $122.6 billion to $105.5 billion – a decline of $17.1 billion. As a per cent of GDP, program spending will decline to 12 per cent, the lowest ratio since 1949-50.

Fiscal outlook with budget measures

Table 7.1 summarizes the fiscal outlook with budget measures, in absolute terms and relative to the size of the economy.

Table 7.1
Summary statement of transactions: fiscal outlook with budget measures

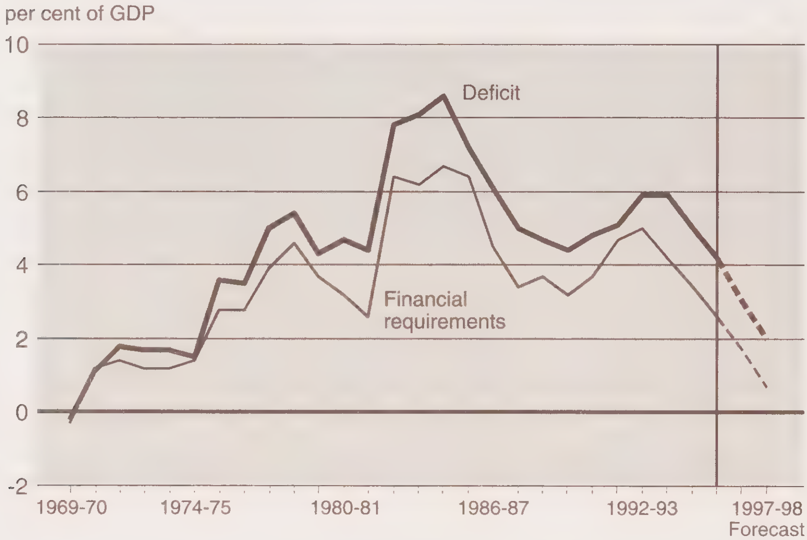
	1993-94	1994-95	1995-96	1996-97	1997-98
			(billions of dollars)		
Budgetary revenues	116.0	123.3	130.6	135.0	141.0
Program spending	-120.0	-118.7	-113.8	-109.0	-106.0
Operating balance	-4.0	4.6	16.8	26.0	35.0
Public debt charges	-38.0	-42.0	-47.0	-47.8	-49.0
Underlying deficit	-42.0	-37.5	-30.2	-21.8	-14.0
Contingency reserve			-2.5	-2.5	-3.0
Deficit	-42.0	-37.5	-32.7	-24.3	-17.0
Non-budgetary transactions	12.2	11.6	12.7	10.6	11.0
Financial requirements	-29.8	-25.8	-20.0	-13.7	-6.0
Net public debt	508.2	545.7	578.4	602.7	619.7
GDP (calendar year)	712.9	750.1	780.0	806.0	841.0
Per cent of GDP					
Revenues	16.3	16.4	16.7	16.7	16.8
Program spending	-16.8	-15.8	-14.6	-13.5	-12.6
Deficit	-5.9	-5.0	-4.2	-3.0	-2.0
Financial requirements	-4.2	-3.4	-2.6	-1.7	-0.7
Net public debt	71.3	72.8	74.2	74.8	73.7

- The 2-per-cent deficit-to-GDP target in 1997-98 is the lowest ratio since the mid-1970s (Chart 7.1).

- Financial requirements – a measure of net new borrowing requirements on credit markets – will decline from 3.4 per cent of GDP in 1994-95 to 0.7 per cent in 1997-98. Financial requirements are a more comparable measure of the government's fiscal position on an international basis, especially with respect to the United States. On this basis, Canada will be close to a balanced budget.

Chart 7.1

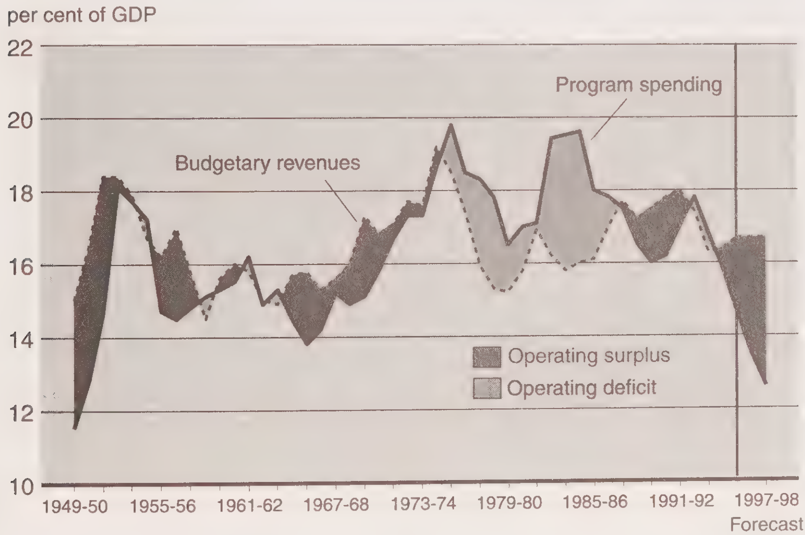
Public accounts deficit and financial requirements



- The operating balance – the difference between budgetary revenues and program spending – will swing from a deficit of $4.0 billion in 1993-94 to a surplus of $35.0 billion in 1997-98. (Chart 7.2).
- The improvement in the operating balance is attributable to a sharp reduction in program spending.
- By 1997-98, the ratio of program spending to GDP is expected to fall to 12.6 per cent – its lowest ratio since 1949-50.
- Budgetary revenues as a per cent of GDP are expected to remain relatively stable over the outlook period.

Chart 7.2

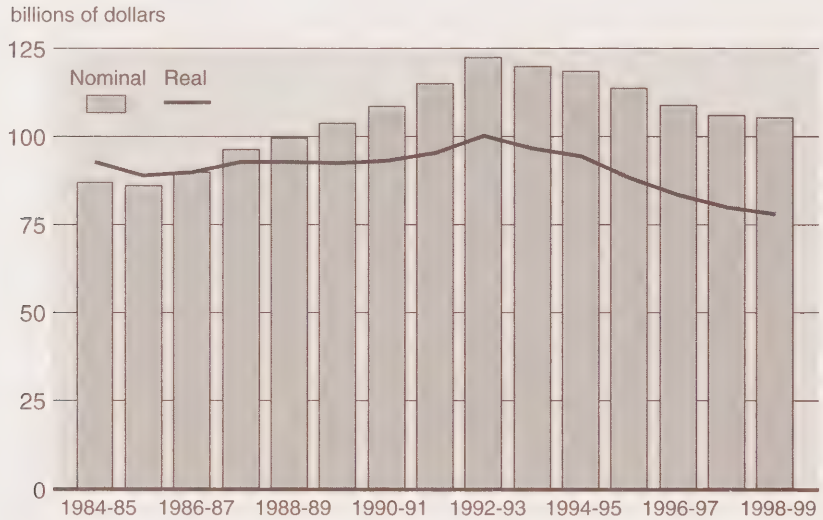
Program spending and budgetary revenues



- With the actions in this budget, program spending is expected to fall to $105.5 billion in 1998-99, the sixth consecutive annual decline in program spending (Chart 7.3). This will leave the level of program spending in 1998-99 at its lowest level (in nominal terms) since 1990-91.
- Adjusted for inflation (CPI less indirect tax changes), the decline in program spending will be much larger. Real program spending in 1998-99 will be 23 per cent below its 1992-93 level and 17 per cent below its 1984-85 level.

Chart 7.3

Program spending: real and nominal



■ The actions taken in this budget and the previous two budgets will significantly slow the rate of growth in net public debt. The debt-to-GDP ratio is expected to peak in 1996-97, following two decades of virtually uninterrupted increases. By 1997-98, growth in debt will be less than growth of GDP, resulting in the first meaningful decline in the debt-to-GDP ratio since 1974-75 (Chart 7.4). In 1997-98 the debt-to-GDP ratio will fall by more than 1 percentage point (Chart 7.5).

Chart 7.4

Growth in federal net debt and GDP

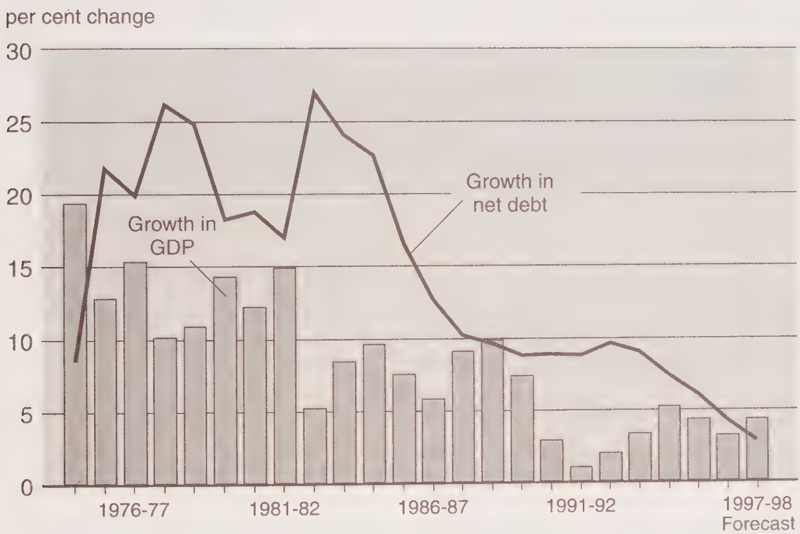
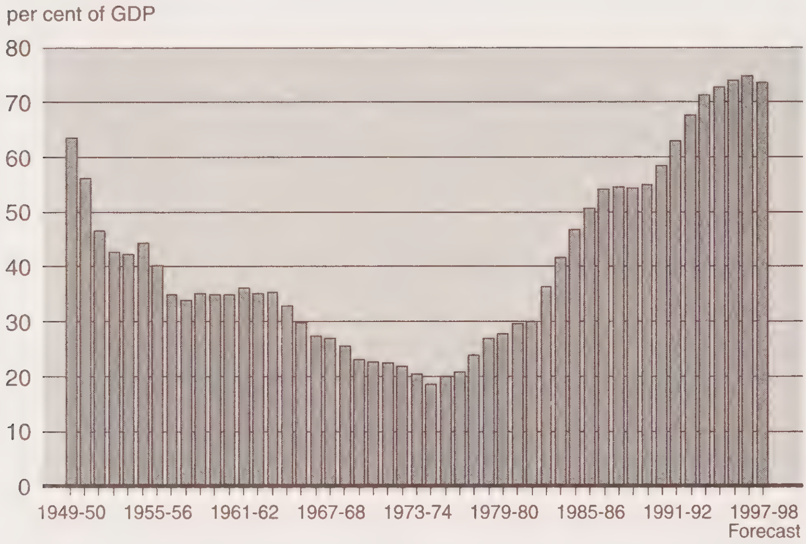


Chart 7.5
Federal government net debt
(public accounts basis)



Sensitivity to Changes in Economic Assumptions

Estimates of the main fiscal aggregates are sensitive to changes in economic assumptions – particularly the level of nominal income and interest rates. The following sensitivity estimates capture the direct fiscal impacts of changes, one economic variable at a time. These are partial calculations. For example, in the nominal income sensitivity estimate, there is no feed-through of the change in nominal income to other variables, such as interest rates and unemployment.

Sensitivity to changes in nominal income

A 1-per-cent increase in the level of nominal GDP leads to higher tax bases and therefore higher revenues. Expenditures are lower, primarily due to lower interest costs since the stock of debt is smaller than it otherwise would be.

The ultimate deficit impact would depend on the source of the increase in nominal incomes. The most favourable impact on the fiscal situation would occur if all of the increase in nominal GDP resulted from increased productivity. Inflation and interest rates would not rise and indeed could decline. Revenues would be higher and borrowing costs lower.

If, however, the improvement in nominal GDP were solely due to inflation, then some of the positive impact on government revenues would be offset by higher spending on those programs indexed to inflation. In addition, higher nominal GDP, caused either through higher inflation or stronger demand in the economy, would likely raise interest rates, thereby increasing public debt charges.

Assuming the increase in nominal incomes comes solely from an increase in real output, the deficit would be lowered by $1.3 billion in the first year, rising to $1.7 billion after four years, as savings from lower debt charges begin to accumulate (Table 7.2).

Table 7.2
Fiscal sensitivity analysis: 1-per-cent increase in nominal income

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	1.2	1.3	1.4	1.6
Expenditure reductions	0.1	0.2	0.1	0.1
Deficit reduction	1.3	1.5	1.5	1.7

Sensitivity to changes in interest rates

In contrast to the uncertainties of the sensitivity of the deficit to changes in nominal GDP, the direct impact of interest rate changes on public debt charges can be calculated with considerable precision.

A sustained 100-basis-point decline in all interest rates would cause the deficit to decline by $1.3 billion in the first year (Table 7.3). As longer-term debt matures and is refinanced at the lower interest rates, the favourable impact on the deficit increases, such that by year four, the deficit is about $3.0 billion lower.

Table 7.3
Fiscal sensitivity analysis: 100-basis-point decline in all interest rates

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue decrease	0.3	0.4	0.4	0.4
Expenditure reductions	1.7	2.6	3.0	3.4
Deficit reduction	1.3	2.2	2.6	3.0

These estimates are somewhat lower than estimates contained in previous years as the government is rebalancing its stock of debt more towards longer-term fixed-rate instruments, bringing Canada more in line with international standards. This will result in a more stable and prudent debt structure.

Sensitivities and the use of prudent economic assumptions and the Contingency Reserve

The deficit targets are based on prudent economic assumptions and include sizeable Contingency Reserves.

As noted in Chapter 6, the interest rate assumptions have been set at 50 basis points higher than the average private sector forecast for 1996 and 80 basis points higher for 1997 and growth has been lowered correspondingly. These impacts have been built directly into the fiscal projections, providing a buffer against adverse economic developments.

In addition, the fiscal projections include a Contingency Reserve of $2.5 billion for 1996-97 and $3.0 billion for 1997-98. The sensitivity analysis above suggests that these Contingency Reserves could absorb a “shock” consisting of an additional 100-basis-point increase in interest rates, combined with a half-percentage point slower growth relative to the prudent planning assumptions.

The use of prudent economic assumptions and the inclusion of the Contingency Reserves therefore implies that the deficit targets can be met under a wide range of adverse developments.

Implications for the Fiscal Outlook in 1998-99

The sensitivity of the fiscal projections to economic developments, especially for budgetary revenues and public debt charges, increases as the forecast period is lengthened. As a result, the budget does not contain fiscal projections beyond 1997-98 for budgetary revenues and public debt charges. Changes to program spending, especially since 1994, have resulted in it becoming less sensitive to changes in the economy. Reflecting this greater certainty, a forecast of program spending is provided for 1998-99, in order to show the impact of the spending reductions in that year on total program spending.

A perspective on overall fiscal prospects and deficit target for 1998-99 will be provided in the 1997 budget. However, a simple extrapolation to 1998 of the economic assumptions contained in Chapter 6, coupled with the impact of the fiscal actions announced in this budget, can provide some insight into the outlook for budgetary revenues and public debt charges and thus the deficit beyond 1997-98.

The fiscal outlook for 1998-99 will be largely determined by the following factors:

- the impact of actions taken in this budget and the previous two budgets on 1998-99;
- the interest rate outlook for 1998; and
- the economic growth outlook for 1998.

Gross spending reductions and revenue-enhancing measures amounting to $2.3 billion in 1998-99 are announced in this budget, of which $0.6 billion is being redirected to high priority initiatives. With net fiscal savings of $1.7 billion in 1998-99 will be realized as a result of actions proposed in this budget. The spending reduction actions announced in this budget, coupled with the measures in each of the last two budgets, will ensure that program spending will be $500 million lower in 1998-99 than in 1997-98.

Budgetary revenues will be higher in 1998-99 than in 1997-98, due to growth in the economy and hence the applicable tax bases. With higher revenues and lower program spending, the surplus in the operating balance will continue to increase.

If interest rates in 1998 remain at their 1997 levels, the average effective interest rate on the public debt will continue to fall as bonds issued at the higher rates of the 1980s and early 1990s are refinanced. This decline in average effective interest rates should be sufficient to offset most of the effect of compounding interest of the current stock of debt.

With an increased operating balance and little change in public debt charges, the deficit, financial requirements, and the debt-to-GDP ratio will all continue to decline in 1998-99.

Changes from the 1995 Budget Forecast

The key factor affecting the fiscal outlook is the changed economic assumptions as described in Chapter 6. That chapter provided an update of the economic developments for 1995 and 1996 from those presented in the February 1995 budget. It also provided a prudent economic scenario for fiscal planning purposes for 1996-97 and 1997-98.

As explained in Chapter 6, economic growth in 1995 is expected to have been significantly weaker than assumed in the February 1995 budget. As a result, tax revenues will be lower than had been expected. Offsetting the weaker-than-expected revenues, interest rates in 1995 were significantly lower than assumed in the February 1995 budget, thereby resulting in much lower-than-expected public debt charges.

These broad trends are apparent in the financial results for the first nine months of 1995-96. The deficit over the period April to December 1995 was $3.3 billion lower than in the same period of 1994-95. This coupled with the inclusion of a number of one-time restructuring costs in 1994-95, clearly indicates that the deficit target for 1995-96 will be met. In addition, if the Contingency Reserve or part of it is not needed, then the final deficit outcome will be that much lower. Final deficit results will be dependent upon economic developments over the balance of the year as well as end-of-year accounting adjustments. Details will be published in the *Annual Financial Report*.

Table 7.4
The fiscal outlook – changes since 1995 budget

	1995-96	1996-97
	(billions of dollars)	
February 1995 budget deficit track	-32.7	-24.3
Impact of economic factors		
Personal income tax	-0.1	1.0
Corporate income tax	1.2	1.2
Sales and excise taxes	0.5	0.6
Employment insurance premiums	1.2	-0.3
Other revenues	-0.2	0.0
Employment insurance benefits	-0.8	0.1
Transfers to provinces	0.3	-0.2
Other program spending	0.3	0.5
Public debt charges	-2.5	-2.9
Net change	0.0	0.0
Net impact of policy measures	0.0	0.0
March 1996 budget deficit	-32.7	-24.3

Note: (-) indicates a reduction in the deficit, (+) indicates an increase in the deficit.

Financial requirements, excluding foreign exchange transactions, were estimated at $24.9 billion in the 1995 budget. Given the financial results to date, this estimate has been lowered to $20 billion. Part of this improvement is due to the cash proceeds from the sale of Petro Canada shares and Canadian National Railways. Although the deficit impact of such sales is based on the proceeds in excess of book value, financial requirements are affected by the net cash generated by such sales.

For 1996-97, the net impact of economic developments is also expected to be offsetting, as the impact of slower growth on the tax bases is expected to be offset by the effect of lower interest rates on public debt charges.

The Revenue Outlook

The revenue outlook to 1997-98 is summarized in Table 7.5.

Based on the financial results for the first nine months of 1995-96, budgetary revenues are estimated at $130.6 billion for the fiscal year as a whole – up $7.3 billion in 1995-96, or 5.9 per cent (Table 7.5). This rate of increase is greater than the growth rate in the economy, reflecting the impact of special one-time factors that depressed revenues in 1994-95, as well as the impact of measures introduced in previous budgets to tighten tax preferences and to increase excise tax rates.

Table 7.5
The revenue outlook

	1993-94	1994-95	1995-96	1996-97	1997-98
	(billions of dollars)				
Personal income tax	51.4	56.3	60.5	63.5	67.2
Corporate income tax	9.4	11.6	14.4	15.1	16.0
Employment Insurance contributions	18.2	18.9	18.5	18.8	19.5
Excise taxes and duties					
Goods and Services Tax	15.7	16.8	17.2	17.9	18.7
Customs import duties	3.7	3.6	3.0	2.8	2.5
Other excise taxes	7.3	6.7	7.3	7.6	7.7
Other tax revenues	1.6	1.8	1.9	1.9	2.0
Total tax revenues	107.3	115.7	122.8	127.6	133.6
Non-tax revenues	8.7	7.6	7.8	7.4	7.4
Total budgetary revenues	116.0	123.3	130.6	135.0	141.0
Per cent of GDP	16.3	16.4	16.7	16.7	16.8

In both 1996-97 and 1997-98, the rate of growth in budgetary revenues closely mirrors the growth in nominal income assumed in the prudent economic planning assumptions. As a result, budgetary revenues as a share of GDP remain relatively stable over the outlook period.

Personal income tax, the single largest source of federal revenues, is expected to increase 7.4 per cent in 1995-96. This increase reflects a combination of higher withholding from employment income and increased instalment payments, reflecting increases in employment earnings, and higher taxes paid on filing relating to the 1994 taxation year. Personal income tax rates have not been increased in any of the 1994, 1995 and 1996 budgets. In both 1996-97 and 1997-98, personal income tax collections are expected to grow slightly faster than the economy, primarily due to the progressivity of the personal income tax system, with higher marginal tax rates at higher levels of taxable income. In addition, with inflation expected to remain well within the inflation-control targets, there will be no indexation of the personal income tax parameters.

The strong growth in corporate profits in 1995 is expected to increase corporate income tax collections to $14.4 billion in 1995-96, an increase of 23.7 per cent from 1994-95. Thereafter, the growth in collections slows significantly due to the expected slowdown in the growth of corporate profits. Actions taken in recent years to maintain the corporate tax base should provide for greater stability in corporate income tax collections in the future.

Employment insurance premium contributions declined in 1995-96, as recoveries were made from the Account for overpayments relating to the 1994 taxation year. Contributions are expected to increase in both 1996-97 and 1997-98 as the effect of increased contributors reflecting improved labour market opportunities offsets the declines in premium rates and for 1996, the decline in maximum insurable earnings. For the purposes of this projection, employee premium rates are assumed to decline by 5 cents in 1997. Actual rates for 1997 will be set by the Minister of Human Resources Development and the Minister of Finance in the fall of 1996.

The growth in Goods and Services Tax (GST) revenues slowed in 1995-96, due to an increase in refunds and weak growth in final consumer demand. In both 1996-97 and 1997-98, GST collections are expected to grow more in line with the growth in final consumer demand.

Customs import duties are expected to continue to be lower over the outlook period, as the effect of tariff reductions under the various trade agreements more than offsets the growth in imports. Other excise taxes were up in 1995-96 due to the increase in

gasoline excise tax rates introduced in the 1995 budget, dampened somewhat by refunds relating to the former Manufacturers' Sales Tax. Thereafter, collections increase slowly.

Non-tax revenues include return on investments, most notably Bank of Canada profits and Exchange Fund earnings, user fees and charges, and other charges. Non-tax revenues are expected to be up in 1995-96 to $7.8 billion, due to the proceeds from the sale of government assets in excess of book value. Thereafter, non-tax revenues are expected to fall to about $7.4 billion in 1996-97 and 1997-98.

Outlook for Program Spending

Table 7.6 provides the major elements of program spending to 1998-99 to provide an overview of the impact of the measures introduced in this, and each of the last two budgets. As a result of these measures, program spending is expected to decline every year over the outlook period, falling from $118.7 billion in 1994-95 to $105.5 billion by 1998-99. As a per cent of GDP program spending falls to 12.0 per cent in 1998-99 – the lowest level of program spending, relative to the economy, since 1949-50. All major components of program spending contribute to this absolute decline in program spending with the exception of major transfers to persons.

Within major transfers to persons, elderly benefits are projected to increase by 3.8 per cent on an annual average basis over the 1994-95 to 1998-99 period. This reflects growth in the age group eligible to receive elderly benefits and increases in the average benefits, which are indexed to changes in the Consumer Price Index. The proposed Seniors Benefit is scheduled to come into effect in 2001. Reform measures introduced in previous budgets as well as the measures proposed last December have significantly restrained the growth in employment insurance benefits. These insurance benefits are expected to be lower in 1998-99 than in 1994-95 and well below the peak of $19.1 billion reached in 1992-93. The government will proceed to put a new Employment Insurance system in place for July 1, 1996, which respects the fiscal parameters established for UI reform. It will be responsive to the realities of the Canadian job market and will ensure that the impact of changes does not fall unfairly on workers who are most in need of support. The government will be implementing the measures on maximum insurable earnings and maximum benefits payable previously contained in Bill C-112.

Cash transfers to other levels of government are projected to fall from $26.7 billion in 1994-95 to about $20 billion by 1998-99. Part of this decline is due to the reduction in entitlements through 1997-98 under the Canada Health and Social Transfer (CHST) – the block-funded transfer introduced in the February 1995 budget, which replaced transfers under the Established Programs Financing (EPF) and Canada Assistance Plan (CAP) programs. However, the CHST entitlement takes the form of tax point transfers and cash transfers. A tax point transfer involves the transfer of federal "tax room" to provinces, which allows the provinces to raise their tax rates by an equivalent amount, with no impact on taxpayers. The cash transfer is the difference between the entitlement and the value of the tax transfer. Over the period 1994-95 to 1998-99, the value of the tax transfer to provinces is projected to grow continuously, accounting for over one-third of the decline in cash transfers. The cash transfer is the only part of the federal contribution under the CHST that is included in federal program spending. As stated in Chapter 4, CHST entitlements will be maintained at $25.1 billion until 1999-00 and then increase. There is also a guarantee that the cash transfer component will not fall below $11 billion.

Equalization transfers are expected to increase by more than $1 billion over the outlook period, while transfers to the territories remain essentially flat.

The Alternative Payments for Standing Programs represent recoveries of a federal tax point abatement under the contracting-out arrangements. Under these arrangements, any province was permitted to assume the administrative and financial authority for certain federal-provincial programs. Quebec was the only province to choose these arrangements when they were offered in the mid-1960s. As a result, the federal government reduced federal personal income tax rates in Quebec so that the province could increase its personal income tax rate by an equivalent amount. Under the CHST, Quebec's entitlements are determined in the same way as for the other provinces. Previously, the value of the additional tax points abated were deducted from EPF and CAP cash transfers otherwise payable. These recoveries will now be shown separately and recovered from cash payments. This change has no impact on the net federal transfer or on Quebec's net receipts.

Table 7.6
The outlook for program spending

	1994-95	1995-96	1996-97	1997-98	1998-99
	(billions of dollars)				
Major transfers to persons					
Elderly benefits	20.5	21.2	21.9	22.8	23.8
Employment insurance	14.8	13.5	13.8	14.2	14.5
Total	35.3	34.7	35.7	37.0	38.3
Major transfers to other levels of government[1]					
EPF/CAP — CHST	18.8	18.5	15.0	12.5	11.8
Equalization	8.5	8.7	8.8	9.2	9.6
Transfers to territories	1.2	1.2	1.1	1.1	1.1
Other fiscal transfers	0.0	0.1	0.0	0.0	0.0
Alternative payments for standing programs	-1.8	-1.9	-2.0	-2.1	-2.2
Total	26.7	26.6	23.0	20.6	20.2
Subsidies and other transfers					
Business subsidies	3.7	2.9	2.0	1.6	1.5
Indians and Inuit	3.7	4.0	4.3	4.3	4.4
International assistance	2.9	2.2	2.2	2.1	1.9
Science and Technology	1.0	0.9	0.9	0.8	0.8
Canada Infrastructure Works	0.4	0.9	0.5	0.1	0.0
Other	8.3	6.6	5.7	5.1	4.6
Total	20.0	17.6	15.5	14.0	13.3
Crown corporations	5.0	4.4	4.2	3.9	3.8
Defence	10.7	10.3	9.8	9.1	8.5
All other spending	21.0	20.1	20.8	21.4	21.4
Program spending	118.7	113.8	109.0	106.0	105.5

[1] Through to 1995-96 includes Established Programs Financing (EPF) and Canada Assistance Plan (CAP). Beginning in 1996-97, refers to the Canada Health and Social Transfer (CHST).

Total entitlements under the EPF/CAP and CHST	29.4	29.7	26.9	25.1	25.1
Total entitlements for major transfers to other levels of government (CHST, Equalization and transfers to the Territories)	38.3	38.8	36.0	34.4	34.8

There is a dramatic reduction in the value of subsidy and other transfer payments over the 1994-95 to 1998-99 period. This is attributable to the actions taken in this and the previous two budgets.

- Business subsidies decline by 60 per cent, reflecting substantial reductions in transportation subsidies (the elimination of the *Western Grain Transportation Act* payments and other railway payments), in agricultural subsidies and in the funding to regional agencies. The measures announced in this budget are described in Chapter 3.
- The rate of growth in transfers under the Indian and Inuit programs (DIAND and aboriginal health under Health Canada) is being restrained further. In the 1995 budget, the annual rate of growth was capped at 3 per cent per year to 1997-98. This budget further restrains the rate of growth under these programs.
- Funding for international assistance will be cut by $1 billion over the 1994-95 to 1998-99 period.
- Grants in respect of science and technology – direct grants made by the National Research Council and the university research granting councils – will be relatively unchanged over the forecast period.
- By 1997-98, the last payments will have been made under the Canada Infrastructure Works Program.
- The remaining component, consisting of veterans' allowances and pensions, labour market programs, cultural subsidies, among others, will also decline significantly over the outlook period.

The measures announced in the last two budgets result in lower Crown corporation expenditures and spending on defence to 1997-98. The measures described in Chapter 3 ensure that such expenditures will continue to decline in 1998-99.

All other spending includes departmental operating costs and centrally held funds to assist departments in managing unavoidable cost pressures arising during the fiscal year.

- The 1994 and 1995 budgets introduced measures which reduced the operating costs of departments. A total of 45,000 jobs are to be eliminated by the time these measures are fully implemented. Additional measures are being introduced in this budget which will result in a further reduction in federal employment.
- In the 1995 budget, the government introduced the Expenditure Management System, whereby departments are required to fund most new initiatives from reallocations from existing budgets.

Public Debt Charges

Public debt charges represent the largest component of total government spending, representing 29 per cent of total spending in 1995-96. From another perspective, the government will spend 36 cents of every revenue dollar in 1995-96 for interest on the public debt.

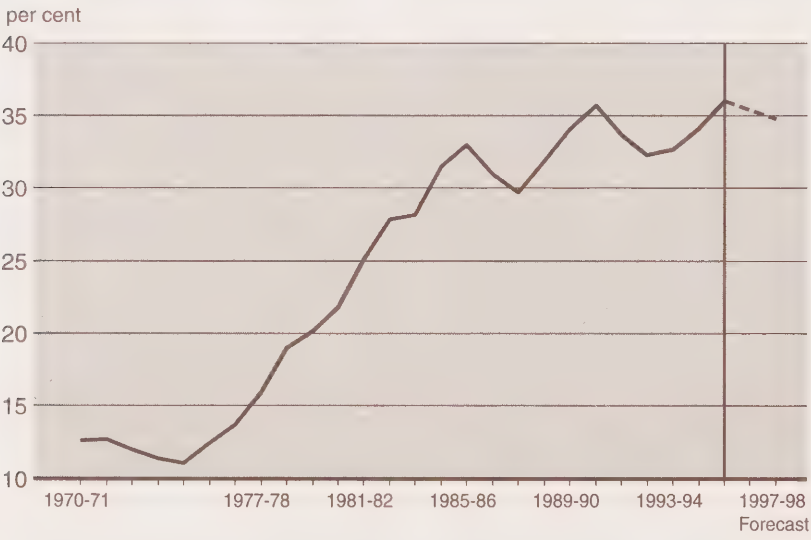
In 1994-95, budgetary revenues exceeded program spending (the operating balance) by $4.6 billion. In 1995-96, an operating surplus of nearly $17 billion is forecast. And this operating surplus is expected to increase to $35 billion by 1997-98. This means that, if it were not for interest payments, the federal budget would now be in a large surplus position.

These large and growing operating surpluses are necessary to offset the effect of cumulative interest on public debt.

By the end of 1994-95, the net federal debt was $545.7 billion. If budgetary revenues just equalled program spending, compound interest alone at today's average rate would cause this debt to grow by almost 50 per cent to more than $800 billion within just five years. By then, annual interest payments would be over $60 billion, about $20 billion more than interest payments in 1994-95.

Chart 7.6

Interest on the debt as a per cent of budgetary revenues



Interest charges amounted to $42 billion in 1994-95. With an operating surplus of about $4.6 billion, nearly all of the interest charges had to be borrowed, adding to the deficit and increasing the base on which the 1995-96 interest payments must be paid.

Over the forecast period, the growth in public debt charges is expected to slow, as the amount of new borrowing declines and the average effective interest rate on the debt begins to fall. New borrowing requirements are expected to be substantially lower than in previous years, as the government meets its deficit targets, with these large operating surpluses. Interest rates declined significantly throughout 1995, and although some increase from current levels is incorporated in the prudent planning assumptions, the average effective interest rate on government debt should continue to decline, as longer-term instruments are refinanced at the lower rates.

As noted earlier in this chapter, the fiscal situation is extremely sensitive to changes in interest rates, given the current stock of debt. As the size of the debt has grown, so has the importance and complexity of managing that debt effectively. The objectives of the government's debt management strategy are: to minimize the cost of funding; to ensure that these costs remain relatively stable over time; to maintain a diverse investor base; and to ensure the continuing development of liquid and well-functioning Canadian financial markets.

Table 7.7
Public debt charges

	1994-95	1995-96	1996-97	1997-98
	(billions of dollars)			
Public debt charges	42.0	47.0	47.8	49.0

The debt management strategy consists of four key elements[1]:

- to achieve a more stable and prudent debt structure by rebalancing the stock of debt more towards longer-term fixed-rate instruments, bringing Canada more into line with international standards;
- to develop a retail debt program aimed at stopping the decline in the retail investor base by providing Canadians with greater opportunities to invest in a range of Government of Canada debt products;

[1] For more details see *Debt Operations Report*, December 1995, Department of Finance.

- to continue to reduce borrowing costs through the development of innovative financing instruments and improvements in the liquidity and efficiency of the Canadian fixed income market; and
- to maintain active relations with investors and credit rating agencies, informing them on a timely basis of Canada's political, economic, fiscal, and debt management developments.

Financial Requirements

Financial requirements provide a measure of the net new borrowing requirements of the federal government in credit markets – that is borrowing over and above that needed to replace maturing debt issues and maintain the existing stock of debt. Financial requirements will fall to $6 billion by 1997-98, from $25.8 billion in 1994-95 (Table 7.8). At 0.7 per cent, this will be the lowest financial requirements relative to GDP since 1969-70.

Table 7.8
Deficit, non-budgetary transactions, and financial requirements

	1994-95	1995-96	1996-97	1997-98
	(billions of dollars)			
Deficit	37.5	32.7	24.3	17.0
Non-budgetary transactions				
Loans, investments and advances	-0.1	3.0	0.7	0.7
Specified purpose accounts	8.7	7.5	8.0	8.4
Other transactions	3.0	2.2	2.0	1.9
Total non-budgetary transactions	11.6	12.7	10.6	11.0
Financial requirements	25.8	20.0	13.7	6.0

Note : Numbers do not add due to rounding.

The difference between financial requirements and the deficit is due to a number of non-budgetary transactions that provide funds to the government. The largest of these is the government's employees pension accounts. Other smaller sources of funds include loans, investments and advances, cash in transit and accounts payable.

Non-budgetary transactions also include accounting adjustments to certain transactions that are reported on an accrual basis to reflect the impact of these on a cash basis. One important adjustment is for restructuring charges. Although restructuring charges adversely affect the deficit in the year in which the liability is incurred, they only affect financial requirements when cash payments are actually made.

Non-budgetary transactions are estimated to be $12.7 billion in 1995-96, up $1.1 billion from 1994-95. This increase is primarily due to the sale of shares in Petro Canada and Canadian National Railways. The net source of funds declines to $10.6 billion in 1996-97 and is expected to increase slightly in 1997-98.

Financial requirements are expected to decline to $20 billion in 1995-96, an improvement of $5.8 billion from 1994-95. By 1997-98, financial requirements are projected to fall to $6 billion. All of this improvement is due to the decline in the deficit over this period, as the net source of funds from non-budgetary transactions is lower in 1997-98 than in 1995-96.

Borrowing Authority

The amount of borrowing authority requested from Parliament for a fiscal year has traditionally been tied to the financial requirements forecast that year, adjusted for estimated Exchange Fund earnings. Borrowing authority to cover the Exchange Fund earnings is sought because these earnings, although reported as budgetary revenues, remain in the Exchange Fund Account and are not available to finance the ongoing operations of government. In addition, a non-lapsing amount of $4 billion is requested, which can either be used during the course of the year to manage contingencies, such as unexpected foreign exchange requirements, or be carried forward temporarily into the next fiscal year. Any borrowing authority remaining above that amount at the end of the fiscal year lapses.

The government plans to modestly increase foreign exchange reserves reflecting increased flows and volatility in foreign exchange markets.

The government will be introducing legislation seeking borrowing authority of \$18.7 billion, consisting of financial requirements of \$13.7 billion, expected Exchange Fund earnings of \$1.0 billion and \$4 billion of non-lapsing authority (Table 7.9).

Table 7.9
Borrowing requirements

	1996-97
	(billions of dollars)
Deficit	-24.3
Non-budgetary transactions	10.6
Financial requirements (excluding foreign exchange requirements)	-13.7
Exchange fund earnings	-1.0
Non-lapsing authority	-4.0
Total borrowing authority requested	-18.7

Annex 1

The Government's Response to the Auditor General's 1995 Report and Observations on the Financial Statements

The 1995 *Report of the Auditor General of Canada* contains information and recommendations covering numerous government programs, government departments and other issues of financial management. In addition, the Auditor General has suggested changes in the federal government's accounting practices in his "Observations" on the 1994-95 *Financial Statements of the Government of Canada.*

The following discusses the government's response to the suggestions by the Auditor General that are of direct relevance to the budget-making process. This concerns Chapter 9 of the Report – which argues the need for better public information on deficits and debt – and three specific accounting matters raised in the Auditor General's Observations. These accounting matters are:

- the treatment of investments in Crown corporations;
- the capitalization of physical assets; and
- the accounting for environmental liabilities.

The Need for Better Information About Public Debt

Chapter 9 of the Auditor General's 1995 Report argued that "Canadians have been preoccupied with deficit reduction without putting it in the context of a long-term goal of the amount of debt we can afford to carry that is consistent with our views about taxation and the size and role of government." Towards providing this long-term context, the Auditor General recommended that the government provide more information about the long-run implications of current policy actions. As well, the Auditor General recommended that steps be taken to improve the understanding of public sector financial information. In a similar vein the January 1996, *Twenty-fourth Report of the Standing Committee on Finance* recommended that "... future budgetary policy should focus less on the level of the annual deficit and more on the relative level of our national debt."

The level of federal debt in Canada is too high and Canadians have clearly stated that they want federal public finances restored to health. Chapter 2 of this document argued that public concern about the debt burden in Canada is well founded. Canada's high debt burden compromises the growth potential of the economy and, ultimately, the Canadian standard of living.

The government came into office facing a $42 billion deficit. Reducing this deficit represents an ongoing challenge that has to be met.

Previous governments had consistently set longer-term targets, which were never realized. The fiscal strategy of this government, as noted in Chapter 7, is to concentrate on the achieving of short-term deficit targets – targets that ensure that the deficit will come down at a steady and measured pace. By focusing on two-year rolling deficit targets, the government is held accountable on a current basis to ensure that those targets are in fact met.

As noted in the December 1995 *Economic and Fiscal Update*, the government is committed to reducing the debt-to-GDP ratio both by eliminating the source of that debt – ongoing deficits – and by increasing the growth potential of the economy. Lowering the deficit will put the debt-to-GDP ratio on a downward path. Lowering the deficit will also lower interest rates, which will bolster economic growth and thus further reduce both the deficit and the debt-to-GDP ratio. Structural changes to support and enhance economic efficiency will lead to more jobs and higher incomes.

This, in turn, will result in higher government revenues and lower government spending, thereby reducing the deficit and debt-to-GDP ratio even further.

The strategy has been successful. To date, the deficit targets have been achieved. Moreover, the government has implemented the necessary measures to achieve its deficit targets through 1997-98. This will result in the first substantial decline in federal debt in relation to GDP in over 20 years.

The focus of fiscal policy will remain the achievement of the two-year rolling deficit targets, for the reasons outlined above. This does not preclude a discussion of longer-run objectives of fiscal policy. As a first step towards initiating this discussion, the government has taken action that should increase public understanding of the government's financial reporting systems. There are currently three systems of government financial accounting – each serving a different purpose. A working group has been set up – on the Auditor General's recommendation – charged with the task of generating a better understanding of, and access to, these.

Progress is being made in reducing the differences in concepts, where possible. The revisions to the System of National Accounts in 1997 will reduce some of the current discrepancies between the measure of the deficit on a National Accounts and a Public Accounts basis. In addition, the Financial Management System – which gathers information on all three levels of government using a common framework – is being reviewed to reduce differences with the National Accounts definitions.

Investments in Crown corporations

In his Observations on the 1995 *Financial Statements of the Government of Canada*, the Auditor General recommended that the government revalue its investments in Crown corporations by the amount of the government's share of profits or losses in that year. This is in contrast with the current practice of recording such investments at cost and then providing allowances to take account of reductions or increases in value.

The government has been engaged in a discussion with the Auditor General on this issue for a number of years. With the announced intention to adopt "full accrual accounting" and the privatization of most of its Crown corporations, the government is now prepared to consider adopting this proposal.

Capitalization of Assets

The Auditor General recommended that acquisitions of capital assets by the government should be included in expenditures in any one year only to the extent that the assets are used in that year. This is in contrast to current accounting whereby the costs of acquiring capital assets are recorded as expenditures at the time of acquisition or construction.

As announced in the 1995 budget, the government intends to move to full accrual accounting for budgeting and accounting purposes. The accrual basis, which is widely used in the private sector in Canada, will allow the government to more accurately report the cost of its activities on an annual basis and thereby ensure that it is more accountable to Parliament and the public.

The government will begin the transition to full accrual accounting, starting in 1997-98. This will enable the government to implement the necessary accounting changes and also allow parliamentarians to become accustomed to the new form of reporting.

Environmental Liabilities

The Auditor General recommends that high priority should be given to quantifying the government's potential environmental liabilities, and to determining when these potential liabilities become actual liabilities. As well, the Auditor General recommends that additional steps should be taken to improve disclosure in this area. He is particularly concerned that the government provide a general understanding of the uncertainties inherent in the process of measuring environmental liabilities – including a discussion of the assumptions used to calculate the liabilities and the range of sensitivities to changes in the assumptions.

The government is in the process of developing a policy with regards to its liability in the area.

Annex 2

Canada-United States Fiscal Comparison

Introduction and Overview

Comparisons are often made between Canada's fiscal situation and that of other countries. An endemic problem with international fiscal comparisons is that measures may be used which are not consistent across countries due to different accounting practices.

On a public accounts basis, the Canadian fiscal situation can be consistently compared with that of the United States by contrasting the financial requirements of Canada's federal government (rather than the budget deficit) with the U.S. deficit on a unified budget basis (U.B.B.).

Comparisons with the United States are particularly important for Canada as a result of the substantial interdependence between the U.S. and Canadian economies. Moreover, the high degree of capital market integration among the two countries implies that both Canadian and U.S. fiscal policy have financial repercussions for the Canadian economy.

Accordingly, it is important to relate Canada's fiscal position relative to the United States. The following charts illustrate Canada-U.S. fiscal policy performance using comparable figures for the deficit, program spending and operating balance at the federal level.

The charts indicate that, as a result of persistent efforts to cut program spending, Canadian governments will achieve larger improvements in both their budgetary and operating balances relative to the United States over the next two years.

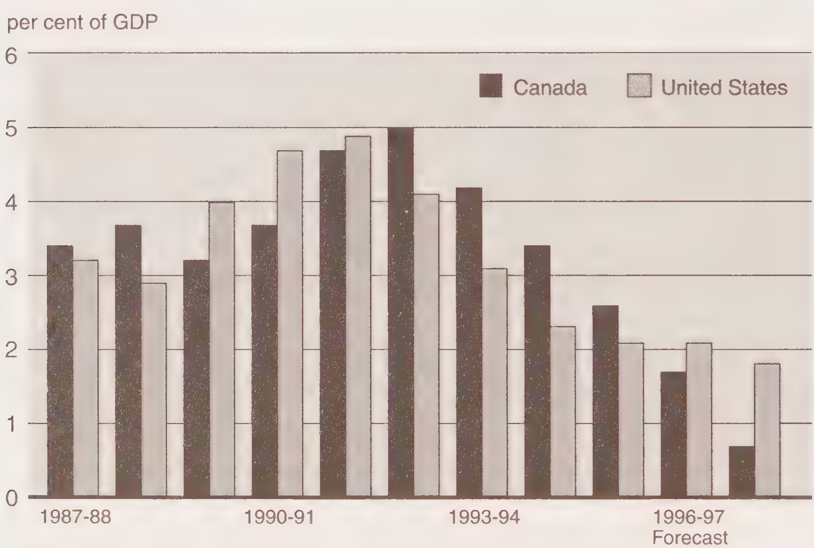
Canada's Deficit-to-GDP Ratio is Falling Significantly Below That of the United States

As can be seen in Chart A2.1, Canada's budget deficits (as measured by financial requirements) relative to GDP have been larger than U.S. government deficits in recent years. With the fiscal measures proposed in this budget, however, compounded with those announced in the 1994 and 1995 budgets, Canada's financial requirements will be reduced sharply.

For 1996-97, Canada's financial requirements are projected to decline by 0.9 percentage points to 1.7 per cent of GDP, while the U.S. deficit ratio is expected to remain stable at 2.1 per cent. The difference between the two ratios will widen further in 1997-98, exceeding a full percentage point in favour of Canada.

Chart A2.1

Federal government deficit in Canada and the United States



Notes: Financial requirements for Canada and the United Budget Basis (UBB) deficit for the United States. Fiscal years ending March 31 and September 30 of the same year for Canada and the U.S. respectively.

Sources: Canada, Department of Finance; the *1997 President's Budget under CBO Assumptions* and the *Budget of the United States Government, Fiscal Year 1996.*

Because program spending is declining more rapidly

Chart A2.2 contrasts the evolution of Canadian and U.S. program spending. The share of Canada's federal program spending to GDP will continue its rapid decline relative to the United States, which is experiencing relatively modest reductions in program spending.

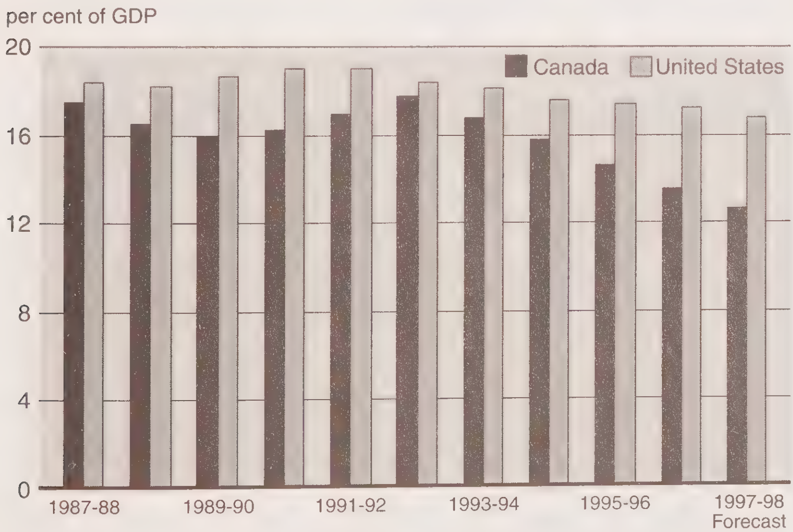
Program spending reduction is the underlying factor driving Canada's fiscal progress.

Between 1994-95 and 1997-98, Canada's federal program spending as a per cent of GDP will decline by 3.2 percentage points compared to only 0.8 percentage points in the United States. Further, program spending in Canada will have fallen by 5.2 percentage points from its peak of 17.8 per cent in 1992-93.

As a result, Canada's federal program spending in 1997-98 will represent only 12.6 per cent of GDP compared to 16.8 per cent in the United States.

Chart A2.2

Federal government program spending



Notes: Total expenditure minus gross debt service charges for Canada and the United States.

Fiscal years ending March 31 and September 30 of the same year for Canada and the United States respectively.

Sources: Canada, Department of Finance; United States, the *Mid-session Review of the 1996 budget* and the *Budget of the United States Government, Fiscal Year 1996*.

Engineering a Substantially Larger Operating Balance Surplus

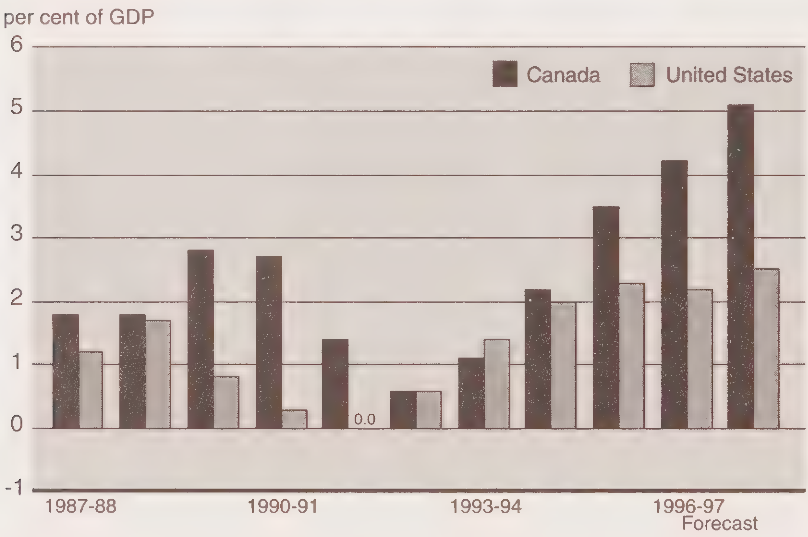
Reflecting the decline in Canadian program spending, both in nominal terms and as a share of GDP, the federal operating balance (total financial requirements less gross public debt charges) as a share of GDP is poised to improve much more rapidly than in the United States. Chart A2.3 illustrates U.S. and Canadian operating balances from 1987-88 to 1997-98.

The Canadian operating surplus will rise to 5.1 per cent of GDP in 1997-98 compared with a surplus of 2.2 per cent in 1994-95. This considerable surplus amounts to more than double the U.S. operating balance as a share of GDP.

The operating surplus is an important measure of a sustainable fiscal policy as such surpluses allow the government to meet its interest obligations or even reduce the stock of public debt relative to GDP. For this reason, the substantial operating surpluses anticipated in Canada are a significant fiscal achievement.

Chart A2.3

Federal government operating balances in Canada and the United States



Notes: Financial requirements less gross debt service payments for Canada and the United Budget Basis (UBB) deficit less gross debt service payments for the United States.

Fiscal years ending March 31 and September 30 of the same year for Canada and the United States respectively.

Sources: Canada, Department of Finance; United States, the *Mid-session Review of the 1996 budget* and the *Budget of the United States Government, Fiscal Year 1996.*

Annex 3

Improved Fiscal Outlook for the Total Government Sector

Introduction and Overview

This annex first provides an assessment of the government financial situation at both the federal and provincial/territorial level. Total government finances in Canada are then contrasted with the fiscal environment of other G-7 countries.

The fiscal situation of the total government sector in Canada in terms of the deficit, program spending and the operating balance has improved significantly in recent years. Further progress is anticipated over the next two years.

In an international context, the rapid amelioration in Canada's public finances will bring about a relatively favourable fiscal setting relative to other major industrialized economies by 1997.

Federal/Provincial/Territorial Fiscal Situation

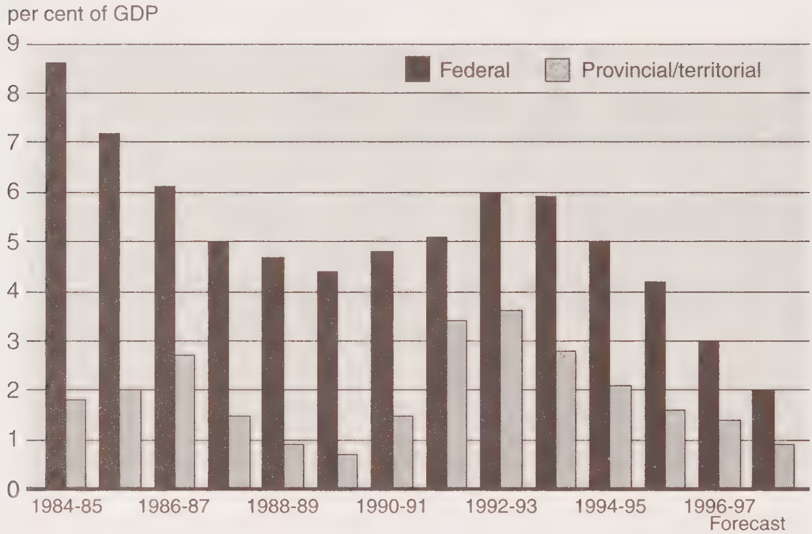
Joint efforts to achieve lower deficits

Both the federal and the provincial/territorial governments have achieved significant progress in reducing their budgetary deficits.

On a public accounts basis, the total government deficit was cut by more than 30 per cent from 1992-93 to 1995-96. As a proportion of GDP, the federal deficit was reduced from 5.9 to 4.2 per cent of GDP, and the provincial/territorial deficit from 3.6 to 1.6 per cent (Chart A3.1).

Chart A3.1

Federal and provincial/territorial budgetary deficits



Source: Department of Finance Canada.

Eight provincial/territorial jurisdictions are expected to report a balanced budget or even a budgetary surplus in 1995-96. Moreover, several provinces have implemented balanced budget legislation and/or announced schedules for the repayment of the public debt.

From a target of 3 per cent of GDP in 1996-97, the federal deficit is projected to decline further to 2 per cent in 1997-98.

This performance, combined with the steady decline in the provincial/territorial deficit, will result in a total government deficit amounting to less than 3 per cent of GDP by 1997-98, from 9.6 per cent in 1992-93.

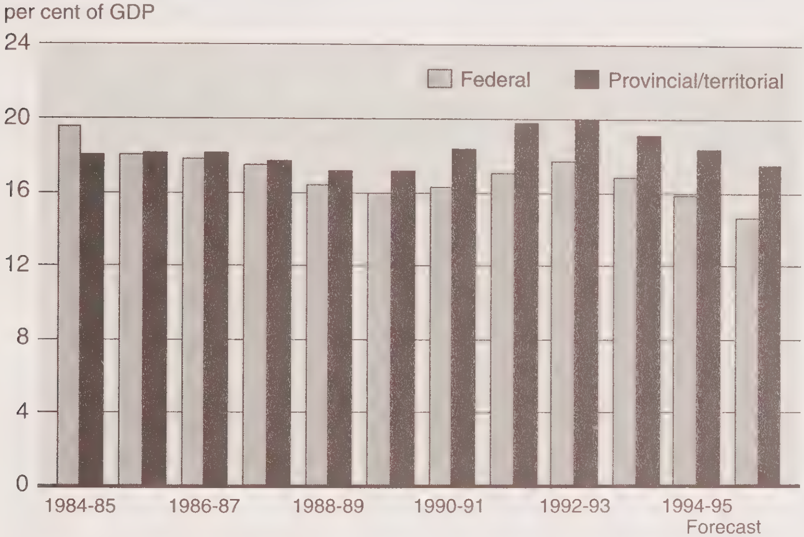
Tight control of program spending is the cornerstone of the deficit reduction strategy

The significant progress achieved by both levels of government in terms of deficit reduction has been anchored in stringent control of public expenditures. In most jurisdictions, major new revenue-raising measures have been avoided in recognition of an already high tax burden and governments' desire to stimulate job creation.

The strategy, at both levels of government, has focused on reducing program spending relative to the size of the economy (Chart A3.2). Federal program spending has declined dramatically over the past three years, falling from 16.8 per cent of GDP in 1993-94 to 14.6 per cent in 1995-96.

Chart A3.2

Federal and provincial/territorial program spending



Source: Department of Finance Canada.

At the provincial/territorial level, the ratio of program spending to GDP declined by 2.5 percentage points between 1992-93 and 1995-96 reaching 17.5 per cent.

Over the next two years, program spending is expected to continue its decline in nominal terms at both levels of government. Consequently, the expected ratios of program spending to GDP will follow a steady downward path, further contributing to deficit elimination. At the federal level, the ratio is expected to be a little more than half of its level in the mid-1970s and mid-1980s.

Resulting in significant operating balance surpluses

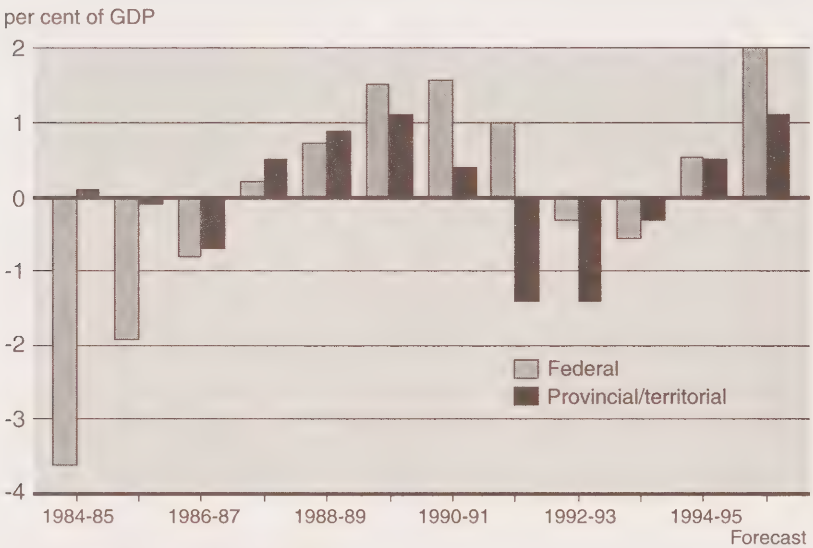
Following the above fiscal policy course has resulted in significantly improved operating budget surpluses, defined as the difference between total budgetary revenues and program spending. An operating surplus is an important indicator of fiscal policy sustainability, particularly with respect to the level of public debt.

At both levels of government, the operating balance shifted from a deficit to a surplus position in 1994-95. This represented a significant fiscal achievement in Canada.

The federal and provincial/territorial operating balances are expected to reach 2.2 and 1.1 per cent of GDP, respectively, in 1995-96 (Chart A3.3).

Chart A3.3

Federal and provincial/territorial operating balance



Source: Department of Finance Canada.

The federal operating surplus is expected to increase by an additional full percentage point in each of the next two years to 4.2 per cent by 1997-98.

Fiscal Progress in an International Context

One problem with international fiscal comparisons is that public accounts figures may not be consistent across countries because of differences in accounting practices. Another issue is that the fiscal responsibilities of each country are shared differently among its levels of government.

To overcome these obstacles, the following charts present Canada and the other G-7 countries on a more consistent basis using national accounts figures for the total government sector.

The charts illustrate that Canada has made remarkable progress in reducing its fiscal imbalance relative to the G-7 countries. As a result of the strong commitment of Canadian governments to fiscal consolidation, the financial situation of the total government sector in this country will improve dramatically by 1997.

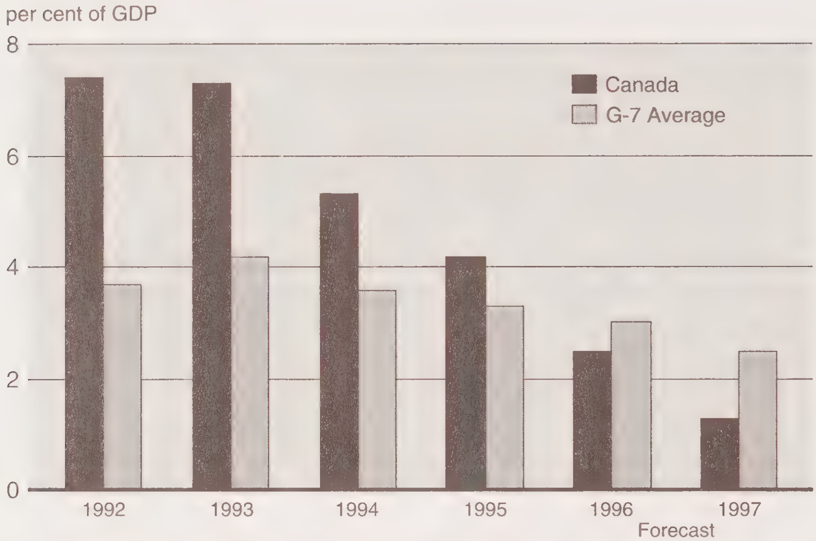
Strong improvement in Canada's relative deficit position

In 1992, the Canadian total government deficit stood at 7.4 per cent of GDP, double the G-7 average.

However, the gap in the deficit between Canada and the G-7 average has been reduced substantially in recent years. In 1996, the Canadian deficit will reach a level *below* the G-7 average (Chart A3.4). Only the United States will have a lower deficit as a percentage of GDP than Canada (Chart A3.5).

Chart A3.4

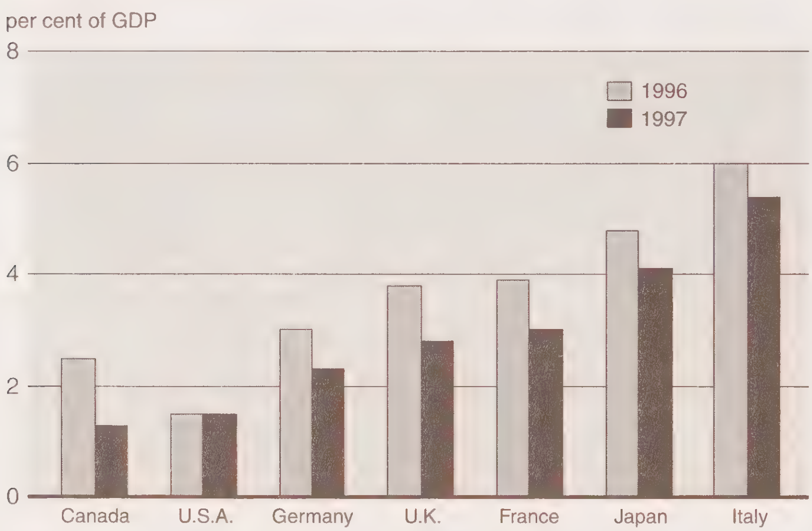
Total government deficit
National Accounts Basis



Sources: Canada, Department of Finance; G-7 Average, OECD Economic Outlook Data, December 1995 using 1991 Purchasing Power Parities.

Chart A3.5

Total government deficit in G-7 countries
National Accounts Basis



Sources: Canada, Department of Finance; G-7 Average, OECD Economic Outlook Data, December 1995.

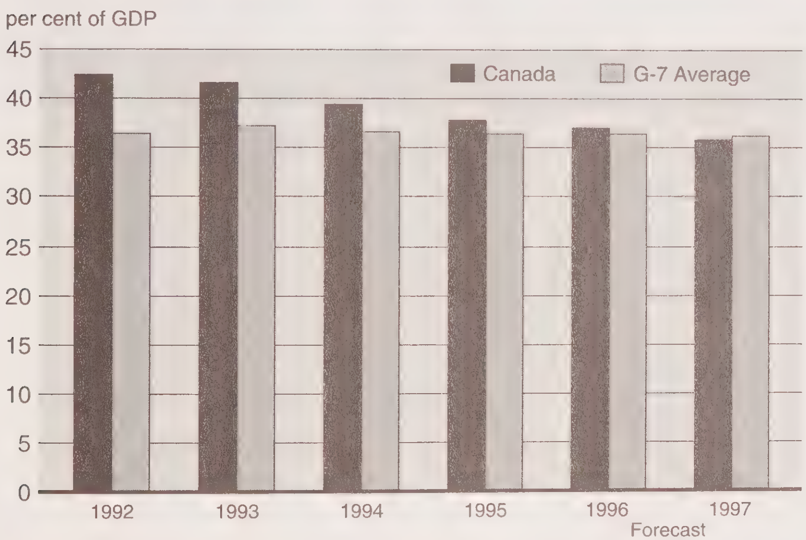
Further, the Canadian total government deficit ratio will fall below the U.S. level in 1997, becoming the lowest among all the G-7 countries.

Reflecting a sharp turnaround in program spending

The gap in program spending as a proportion of GDP between Canada and the G-7 average is also being eliminated (Chart A3.6).

Chart A3.6

Total government program spending
National Accounts Basis

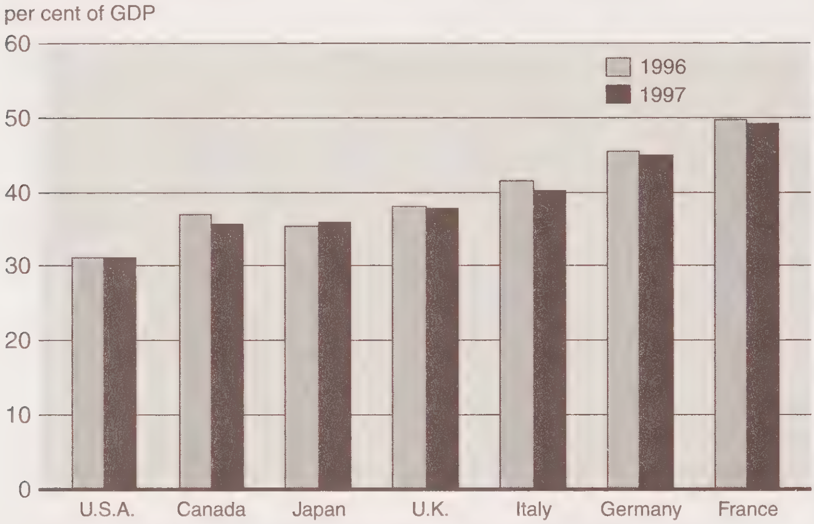


Sources: Canada, Department of Finance; G-7 Average, OECD Economic Outlook Data, December 1995 using 1991 Purchasing Power Parities.

In 1996, the ratio of program spending to GDP in Canada will be the third lowest behind the United States and Japan (Chart A3.7). Canada will surpass Japan by 1997, having the second lowest ratio following the United States.

Chart A3.7

Total government program spending in G-7 countries
National Accounts Basis



Sources: Canada, Department of Finance; G-7 Average, OECD Economic Outlook Data, December 1995.

Leading to a faster decline in the Canadian net debt-to-GDP ratio

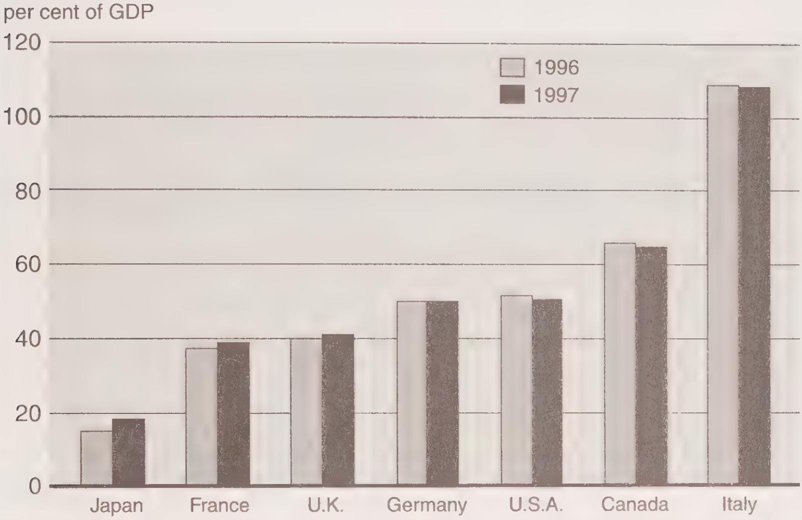
The Canadian net debt-to-GDP ratio is higher than the G-7 average, but is declining much more rapidly due to the positive impact of successful deficit reduction.

In 1997, the Canadian net debt ratio will decline by almost two percentage points, while increasing in a majority of other G-7 countries (Chart A3.8).

Canada's success in reducing the net debt-to-GDP ratio will ultimately bring about a sustainable level of public debt and an increasingly secure fiscal environment.

Chart A3.8

Total government net debt in G-7 countries
National Accounts Basis



Sources: Canada, Department of Finance; G-7 Average, OECD Economic Outlook Data, December 1995.

Annex 4

The Spending Control Act

Compliance with the Spending Control Act

Under the *Spending Control Act*, the government must indicate how the current spending projections comply with the spending limits set out in the Act. The *Spending Control Act* covers all program spending, comprised of total budgetary expenditures less public debt charges, with the exception of expenditures related to a limited number of self-financing programs. Actual and projected spending over the 1991-92 to 1995-96 period cannot exceed the limits set out in the Act.

Actual spending subject to control, as audited by the Auditor General of Canada, for the first four years of the *Spending Control Act* was $9.3 billion below the aggregate spending control limits for these years. Over the remaining year covered by the Act – 1995-96 – spending subject to control is projected to be $12.3 billion below the spending limits for that year. The much lower spending in these years reflects the impact of the fiscal actions proposed in this budget as well as the actions taken in previous budgets.

Table A4.1
The Spending Control Act compliance

	1991-92	1992-93	1993-94	1994-95	1995-96
	(billions of dollars)				
Spending Control Act					
Original limits	97.2	100.9	104.1	107.4	111.3
Expenditures, justified by current/future years' increase in revenues[1]		0.1	0.1	0.1	0.1
Allocating of overspending[2]	-0.6	0.6			
Adjusted spending limits	96.6	101.6	104.2	107.5	111.3
1996 budget program spending[3]	115.3	122.6	120.0	118.7	113.8
Less:					
Expenditures under the *Unemployment Insurance Act*	19.3	20.3	18.9	16.1	14.8
Expenditures under the *Farm Income Protection Act*	0.1	0.1	0.4	0.0	0.0
Expenditures relating to prior years	0.2	0.6	0.1	0.0	0.0
Net adjustments	19.6	21.0	19.3	16.1	14.8
Program spending subject to Spending Control Act	95.6	101.6	100.7	102.7	99.0
Excess (+) or underspending (-)	-1.0	0.0	-3.5	-4.8	-12.3

[1] Pursuant to Section 4 of the *Spending Control Act*, the spending limit for a fiscal year can be modified. In compliance with this section, the President of the Treasury Board may certify that a proposed increase in expenditures for a specific program is justified by reasons of good management. This situation applies only when an increase in expenditures results in an equivalent increase in revenues that would not otherwise occur.

[2] Where program spending exceeds the spending limit for a fiscal year, the excess must be offset through reduced spending in the following two years. Where the spending limit for a fiscal year exceeds program spending, the Minister of Finance may partially or fully allocate the excess to a subsequent fiscal year. In the February 1994 budget, the Minister of Finance allocated part of the 1991-92 underspending ($1,625 million) to cover the excess spending of 1992-93 ($579 million). As a result, the spending limit for 1991-92 was lowered to $96,621 million, while the limit for 1992-93 was raised to $101,577 million.

[3] Data for 1991-92, 1992-93, 1993-94 and 1994-95 are final results as audited by the Auditor General of Canada and reported in the *Public Accounts of Canada*.

The *Spending Control Act* required that the government make a recommendation in the 1994 budget, as to whether or not the *Spending Control Act* should be extended beyond 1995-96. In that budget, the government indicated that it would adhere to the spending limits set out in the current legislation. The government also indicated that it would not be recommending the extension of the *Spending Control Act* beyond 1995-96. Given that spending subject to control is significantly below the spending limits set out in the legislation, extension of this Act is clearly not required to demonstrate control over government spending.

Annex 5

Tax Measures: Supplementary Information and Notices of Ways and Means Motions

Table of Contents

Personal Income Tax Measures

Overview

The government is aware of the heavy tax burden already borne by Canadians and the costs this imposes on the economy. Accordingly, federal tax rates are not being raised. Mirroring the reallocation of spending, however, the budget proposes to reallocate funds among tax expenditures by tightening some preferences and redirecting the savings to high-priority areas.

Table A5.1
Federal revenue impact of personal income tax measures

	1996-97	1997-98	1998-99
		(millions of dollars)	
Getting Government Right			
Reduce Special Incentives for LSVCCs			
Reduce tax credit (to a maximum 15 per cent)	10	45	55
Reduce contribution limit to $3,500	5	15	15
Increase minimum holding period		future savings	
Tax-Assisted Retirement Savings			
Restrict tax assistance to retirement saving	0	40	175
Deny deductibility of RRSP fees	0	5	5
Tax non-residents on worldwide income	10	10	10
Strengthen Revenue Canada's Underground Economy Initiatives	25	60	100
Securing the Future of Social Programs			
New tax treatment of child support	-10	-10	40
Increase the Working Income Supplement	0	-95	-220
Increase assistance for care of infirm dependants	-5	-35	-40
Increase incentives for charitable donations	-5	-20	-20
Investing in the Future			
Supporting Education and Training			
Increase education credit	0	-10	-10
Increase limit on transfer of tuition and education credits	-5	-50	-50
Increase RESP limits	0	-10	-10
Broaden eligibility for child care expense deduction	0	-10	-10
Total personal taxation measures	25	-65	40

In particular, the government is targeting additional tax assistance to low-income parents in the work force, to students and their supporting parents or spouses, and to those making charitable donations or supporting infirm dependants.

Labour-sponsored venture capital corporations (LSVCCs)

To facilitate access to capital for small- and medium-sized enterprises (SMEs), the federal government and most provincial governments provide generous tax assistance in respect of amounts invested by individuals in LSVCCs. As a result of this assistance, investments in LSVCCs have experienced rapid growth over the past few years, increasing from about $70 million for the 1990 taxation year to some $600 million for the 1994 taxation year. At the end of 1995, LSVCCs had more than $2 billion in assets.

By improving access to capital for SMEs, LSVCCs have helped some SMEs create and maintain jobs. However, at the current rate of investment, venture capitalists have more than a three-year supply of capital. Consequently, the budget is proposing a number of changes to limit tax assistance in respect of amounts invested by individuals in LSVCCs.

First, the budget proposes to reduce the rate of the federal LSVCC tax credit from 20 per cent of the cost of LSVCC shares to a maximum of 15 per cent for shares acquired after March 5, 1996. For the 1996 taxation year, as a transition measure, the rate of the federal LSVCC credit will, regardless of the rate of the provincial LSVCC credit, be:

- 20 per cent of the cost of the shares for shares acquired before March 6, 1996; and
- 15 per cent of the cost of the shares for shares acquired after March 5, 1996.

Starting in the 1997 taxation year, the rate of the federal credit will be the lesser of 15 per cent and the rate of the provincial credit. However, to ensure that individuals across the country continue to have the opportunity to invest in LSVCCs, the federal government will maintain a minimum 10 per cent credit for investments in federally registered LSVCCs, regardless of the rate of the provincial credit.

Second, the budget proposes that the maximum annual investment eligible for a federal LSVCC credit be reduced from $5,000 to $3,500 for acquisitions of shares after March 5, 1996.

Third, the budget proposes to increase the minimum holding period normally applying to federally registered LSVCC shares from five years to eight years. This holding requirement will apply equally to individuals retiring, reaching the age of 65, or ceasing to be resident of Canada, who are currently required to hold shares for only two years. This measure is to apply to LSVCC shares acquired after March 5, 1996. Amendments to the articles of incorporation of federally registered LSVCCs to reflect this change of policy will be required to be approved by January 1, 1997.

Fourth, where LSVCC shares are redeemed without repayment of the federal LSVCC tax credit, the individual who was entitled to the federal LSVCC tax credit in respect of the acquisition of those shares will not be allowed to claim the federal LSVCC tax credit for the year in which the redemption occurs and for each of the two following years. This measure is to apply to the 1996 and subsequent taxation years, in connection with shares redeemed after March 5, 1996.

Additional detail on these proposals, together with information on changes of a technical nature, is provided in the accompanying Notice of Ways and Means Motion to amend the *Income Tax Act*.

Measures Relating to Retirement Saving

The budget proposes five measures relating to tax-assisted saving in registered pension plans (RPPs), registered retirement savings plans (RRSPs) and deferred profit sharing plans (DPSPs). The measures will limit the cost of the tax deferral associated with retirement savings while ensuring that tax assistance is targeted at modest- and middle-income Canadians. The proposed measures are:

- a freeze in the pension, RRSP and DPSP contribution limits;
- elimination of the seven-year limit on the carry-forward of unused RRSP deduction room;
- a reduction in the age limit for maturing RPPs, RRSPs and DPSPs;
- elimination of the deduction for RRSP and registered retirement income fund (RRIF) administration fees; and

- a measure to limit the relief from withholding tax applicable to pension income payable to non-residents.

Freeze in the pension, RRSP and DPSP contribution limits

The budget proposes to delay increases in the pension, RRSP and DPSP dollar limits for a number of years. These measures will affect only individuals earning over $75,000. When the phase-in of the modified limits is complete, the limits will provide full tax assistance on earnings up to about two times the average wage.

The RRSP dollar limit will be frozen at $13,500 until 2003, then increased to $14,500 in 2004 and to $15,500 in 2005. Contribution limits for money purchase RPPs will be frozen at equivalent levels. The dollar limit for DPSPs will remain at one-half the money purchase limit for the year. The money purchase RPP and RRSP limits will be indexed to the average wage beginning in 2005 and 2006 respectively (Table A5.2 sets out the existing and modified schedule of RPP and RRSP contribution limits to 2006).

Table A5.2
Dollar limits for contributions to RPPs and RRSPs

	RPPs		RRSPs	
Year	Existing	Modified	Existing	Modified
1996	$13,500	$13,500	$13,500	$13,500
1997	$14,500	$13,500	$13,500	$13,500
1998	$15,500	$13,500	$14,500	$13,500
1999	indexed	$13,500	$15,500	$13,500
2000		$13,500	indexed	$13,500
2001		$13,500		$13,500
2002		$13,500		$13,500
2003		$14,500		$13,500
2004		$15,500		$14,500
2005		indexed		$15,500
2006				indexed

The modified limits take effect as of January 1, 1997. This means that no money purchase pension plans or profit sharing plans will be registered after 1996 unless they comply with the modified limits. It also means that plans registered before 1997 become revocable if they do not comply with the modified limits as of January 1, 1997.

The maximum pension limit for defined benefit RPPs will be frozen at its current level of $1,722 per year of service through 2004 and indexed to the average wage beginning in 2005. This change takes effect as of budget day with the following exceptions: RPPs submitted for registration before budget day which explicitly provide for indexing before 2005 will not have to comply with the modified limit until January 1, 1998; valuation reports for defined benefit RPPs signed before budget day will not have to be redone to reflect the deferral in indexing to 2005 (except with respect to contributions made after 1996 to designated plans); and the change will not apply to an annuity contract acquired under an RPP before budget day in respect of an individual plan member.

There will be no modifications to the rules for determining defined benefit pension credits during the period when the money purchase and RRSP limits are less than $15,500 (in other words, there will be no benefit accrual caps or earnings range exclusions). As a result, high-income earners in defined benefit RPPs will lose all or part of the RRSP room that would otherwise have become available to them each year through 2004.

The fact that there will not be any modifications to the pension credit rules means that a high-income earner in an otherwise acceptable defined benefit RPP could have a pension credit exceeding the money purchase limit. There will be special rules to ensure that this does not cause the RPP to become revocable.

Under existing rules, individuals participating in certain unregistered pension arrangements, e.g., federal judges and Canadian residents who are members of foreign pension plans, may have an amount prescribed by regulation that reduces their RRSP deduction room. However, such individuals are generally left with at least $1,000 worth of RRSP room. The budget proposes to eliminate this RRSP room for high-income earners during those years in which the RRSP limit is less than $15,500.

Elimination of the seven-year limit on the carry-forward of unused RRSP deduction room

To increase flexibility for individuals saving for retirement, the budget proposes to eliminate the seven-year limit on the carry-forward of unused RRSP room accumulated since 1991. This measure recognizes that many taxpayers may go through lengthy periods – early in their careers or when they are raising children – when they are unable to set significant amounts aside for their

retirement. The measure will, over time, make the tax assistance system fairer and more effective by increasing the ability of individuals to utilize their accumulated unused RRSP room in years when they are able to save.

Reduction in the age limit for maturing RPPs, RRSPs and DPSPs

In order to move the age at which individuals must mature their retirement savings closer into line with ages at which most Canadians are now retiring, the budget proposes to reduce to 69 the current age 71 limit for maturing RPPs, RRSPs and DPSPs. This change will still allow individuals four years of tax-assisted savings opportunities past age 65. Under the measure, individuals will not be permitted to contribute to retirement plans or accrue pension benefits after the end of the year in which they turn 69, and will have to start receiving retirement income out of these plans or roll these savings into a RRIF by the end of that year. Employer contributions also will not be permitted after this date.

Individuals who have RRSP deduction room after age 69 will be able to contribute to a spousal RRSP up until the end of the year in which their spouse turns age 69. This is consistent with the current rules which allow individuals with RRSP room who are over age 71 to contribute to a spousal RRSP up until the end of the year in which their spouse turns age 71.

The reduction in the age limit will not apply to individuals who are 70 years of age or more at the end of 1996 – they will be able to mature their plans as if the age limit were still 71. Individuals who turn 69 years of age in 1996 will be required to accelerate maturity by one year – they will have to mature their plans by the end of 1997, the year in which they turn 70 years of age. For all other individuals, i.e. for those persons who are under 69 years of age at the end of 1996, the latest maturity date will be accelerated by two years. For example, persons turning age 68 in 1996 will have to mature their plans by the end of 1997, the end of the year in which they turn 69 years of age.

To avoid requiring individuals to renegotiate annuity contracts, deferred annuities purchased before budget day will be exempt from the new maturation age limit.

The revised maturation requirements take effect as of January 1, 1997. This means that no retirement savings plans, pension plans or profit sharing plans will be registered after 1996 unless they comply with the revised requirements. It also means that (with the exception of RRSPs, as noted below) plans registered before 1997 become revocable if they do not comply with the revised requirements as of January 1, 1997.

RRSPs registered before 1997 will not have to be amended to comply with the revised maturation requirements. However, if such a plan does not mature by the new age limit, it will be subject to deregistration at that time. It is expected that most RRSPs will be amended to reflect the new age limit. However, where this is not the case, the RRSP issuer will be required to inform the annuitant at least six months before the earlier maturity date that the RRSP will be deregistered if it does not mature by that date. An issuer who fails to provide such notification will be subject to penalties under subsection 162(7) of the *Income Tax Act*.

As an additional measure to provide increased flexibility for retirement income options, the budget proposes to allow, after 1995, the transfer of lump sum amounts from a defined benefit RPP to a RRIF after an individual attains 72 years of age. Currently no such transfers are permitted. In general terms, the amount that an individual will be allowed to transfer will be limited to the amount of annual pension given up under the RPP multiplied by the factor corresponding to the individual's age as set out in Table A5.3.

Table A5.3
Prescribed amount factors for transfer of amounts from a defined benefit RPP to a RRIF after age 71

Age at date of transfer	Factor	Age at date of transfer	Factor
72	10.1	85	5.8
73	9.8	86	5.5
74	9.4	87	5.2
75	9.1	88	4.9
76	8.7	89	4.7
77	8.4	90	4.4
78	8.0	91	4.2
79	7.7	92	3.9
80	7.3	93	3.7
81	7.0	94	3.5
82	6.7	95	3.2
83	6.4	96 and over	3.0
84	6.1		

Elimination of the deduction for RRSP and RRIF administration fees

At present, administrative fees for RRSPs and RRIFs are deductible if paid outside the plan. Since other RRSP and RRIF investment expenses are not deductible and these plans already provide generous tax deferrals, the budget proposes to eliminate the deduction for such fees paid on or after budget day.

Limiting the relief from withholding tax applicable to pension income payable to non-residents

Unless a tax treaty provides otherwise, non-residents are subject to a 25-per-cent withholding tax rate on pension income from Canada. However, non-residents can elect to file a Canadian tax return which allows them to pay tax on that income at ordinary rates, rather than the flat withholding tax rate. Under the current rules, only Canadian-source income must be reported for these purposes. As a result, individuals with other income pay less tax on their pension income than they would if they were Canadian residents.

The budget proposes to limit the extent to which relief from the withholding tax rate can be obtained by determining the ordinary tax rate using the greater of Canadian-source or world-wide income. The measure will apply to all elections to reduce the tax withheld on a variety of income sources including Canadian pensions, Old Age Security (OAS), the Canada or Quebec Pension Plan, RRSPs, RRIFs and alimony. This measure is consistent with the treatment of OAS benefits for non-residents introduced in last year's budget.

Strengthening Revenue Canada's Underground Economy Initiatives

An important part of fairness in the tax system is ensuring that everyone pays their fair share of taxes. For this reason, Revenue Canada continues to take measures to strengthen its ability to ensure compliance. The budget proposes to devote more resources to Revenue Canada's audit program for unincorporated businesses and self-employed individuals in order to increase the audit coverage rate for these groups and bring it more in line with the continued growth in this sector. Eight hundred additional auditors will be devoted to this initiative in 1998-99 when it is fully in place at an

annual cost of $50 million. It is expected that additional revenues generated will be about $150 million annually, for a net revenue increase of about $100 million.

Increased Assistance for Families with Children

New tax treatment of child support

Currently, under the *Income Tax Act*, periodic child support payments are deductible to the payer and are included in the income of the recipient for tax purposes.

As of May 1, 1997, child support paid pursuant to a written agreement or court order made on or after that day will not be deductible to the payer nor included in the income of the recipient for tax purposes. Award levels under the new federal child support guidelines are determined based on these new tax rules. These guidelines are described in detail in the federal government document on child support reforms.

Existing child support orders not affected until varied

The new tax rules will generally apply only to court orders or written agreements for child support made after April 30, 1997. Child support paid pursuant to a court order or written agreement made before May 1, 1997 will continue to be deductible to the payer and included in the income of the recipient with the following exceptions:

- where the payer and recipient file a joint election with Revenue Canada that the payer will not, for income tax purposes, deduct from income and the recipient will not include in income payments in respect of child support obligations that arise on or after a specified date (which cannot be earlier than May 1, 1997);
- where the agreement or order is changed or varied after April 30, 1997 to change the amount of child support;
- where after March 5, 1996an agreement or order provides that the payer will not, for income tax purposes, deduct from income and the recipient will not include in income payments in respect of child support obligations that arise on or after a specified date (which cannot be earlier than May 1, 1997).

Once the tax treatment of the child support payments has been changed, parties will not be permitted to return to the old tax rules in respect of support that becomes payable after the new rules apply.

Spousal support not affected

The tax changes do not apply to spousal support. Spousal support payments paid on a periodic basis under a written agreement or court order will remain deductible from income by the payer and included in the income of the recipient for income tax purposes.

Distinguishing between child and spousal support

Where an amount in a written agreement or court order is not identified as being solely for the support of a spouse, it will be treated, for income tax purposes, as an amount of child support. Similarly, where a written agreement or court order provides that certain expenses are to be paid directly to a third party, any such expense that is not clearly identified in the agreement or court order as being solely for the benefit of the recipient spouse will be treated as child support.

Where the total spousal and child support payments made under a written agreement or court order are less than the total payment required under the agreement or court order, the payments will first be considered, for income tax purposes, to be child support. Therefore, payments will be deducted to the payer and included in the income of the recipient only once all child support payments have been made.

Entitlement to the equivalent-to-married credit

The equivalent-to-married credit is provided to a single parent of a child under the age of 18. Currently, the *Income Tax Act* provides that the recipient of child support, not the payer, is eligible to claim the credit.

This treatment will continue to apply under the new rules. This approach is consistent with the new federal child support guidelines, under which award levels are set based on the assumption that it is the recipient spouse who claims the equivalent-to-married credit.

Increase in the Working Income Supplement (WIS)

The Working Income Supplement (WIS) is a component of the Child Tax Benefit. It targets assistance to low-income working families with children by providing an additional annual non-taxable benefit of up to $500 to supplement the employment earnings of families with net income below $25,921. The WIS is phased in at a rate of 8 per cent of annual family earnings in excess of $3,750, to reach $500 at an earnings level of $10,000. The benefit is reduced at a rate of 10 per cent of annual family net income in excess of $20,921. The WIS is part of the Child Tax Benefit and benefits under the WIS are included in monthly Child Tax Benefit cheques.

The WIS helps low-income parents meet some of the extra costs related to participation in the paid labour force, such as child care and transportation to work. Also, the WIS helps make up for the loss of in-kind benefits such as dental care and free drug prescriptions for those parents who leave social assistance and re-enter the labour force.

An increase to the WIS targets the limited resources at the disposal of the government to families with low incomes. It also rewards participation in the labour market for households such as single-parent families on welfare who seek to attain greater financial security. It is thus a very good example of the government's approach to putting policies in place that are mutually reinforcing in the attainment of the overarching objective of more and better jobs for Canadians.

Enriched benefit

Benefits for low-income working families with children will be enriched through a two-step doubling of the WIS. The maximum annual benefit will be increased from $500 to $750 in July 1997, and to $1,000 in July 1998.

The current thresholds will be maintained under the enriched WIS. On July 1, 1997, the supplement will be phased in at a rate of 12 per cent of annual family earnings in excess of $3,750, to reach $750 at an earnings level of $10,000, and will be reduced at a rate of 15 per cent of annual family net income in excess of $20,921.

On July 1, 1998, the supplement will be phased in at a rate of 16 per cent of annual family earnings in excess of $3,750, to reach $1,000 at an earnings level of $10,000, and will be reduced at a rate of 20 per cent of annual family net income in excess of $20,921.

Enriching the credit for infirm dependants

Many Canadian families provide care and support for infirm relatives. The existing tax system recognizes that low-income people with disabilities are often supported and cared for by family members.

- Individuals supporting a spouse, child, grandchild, parent, or grandparent with a severe and prolonged mental or physical impairment, may claim unused amounts of the disability tax credit.
- Supporting individuals may claim the medical expense tax credit for qualifying expenses incurred on behalf of a dependent relative (spouse, child, grandchild, parent, grandparent, brother, sister, uncle, aunt, niece or nephew).
- Up to $5,000 in respite care expenses may be claimed under the medical expense tax credit.
- Individuals supporting relatives (children 18 or over, parents, grandparents, brothers, sisters, aunts, uncles, nieces or nephews) with a mental or physical infirmity may claim the credit for infirm dependants. This credit reduces the federal tax of a supporting relative by up to $270. The value of the credit is reduced by 17 per cent of the net income of the dependant in excess of $2,690.
- Single individuals may claim the equivalent-to-married credit for dependent parents, grandparents, or other relatives either under 18 years of age or dependant because of a mental or physical infirmity.

To enhance the tax assistance provided to individuals caring for dependent relatives, the maximum credit for infirm dependants will be increased from $270 to $400. The threshold at which the phase-out of the credit begins will also be increased from $2,690 to $4,103 of the dependant's net income.

These changes will assist individuals supporting infirm dependants with less than $6,456 in net income.

Increasing the Annual Limit on Tax Credits for Charitable Donations

Charities play a very important role in providing services to Canadians. In recognition of this, substantial support is currently provided to charities through the tax system. Individuals receive a federal tax credit of 17 per cent on the first $200 donated and 29 per cent on any remaining eligible portion of donations made in the year. Since the credit affects surtaxes and provincial taxes, the 29 per cent credit generates total tax savings of about 50 cents for each dollar donated. Corporations claim a deduction in computing taxable income.

Claims for gifts to charities are currently limited to 20 per cent of the donor's net income in a year. Unused claims may be carried forward for up to five years, and may be carried back one year for gifts made in the year of death.

In most cases, donors are able to claim the full value of the credit for their donations in the year in which donations are made.

However, in some cases, the existing system does not allow the most generous donors to claim the full amount of their donations, and more often does not allow the credit to be claimed in the year donations are made. This lack of immediate recognition of donations can be a serious impediment to charitable giving, especially for bequests or legacies. The current regime can also be a problem in the case of donations of appreciated capital property.

In order to further assist the important work undertaken by charities, this budget proposes three changes:

- the general annual limit on charitable donations as a percentage of net income will be raised from 20 per cent to 50 per cent;
- the limit on gifts by individuals in the year of death and the preceding year, including bequests or legacies, will be raised from 20 per cent to 100 per cent; and
- the limit of 50 per cent of net income will be further raised by half the amount of taxable capital gains resulting from the donation of capital property that are included in calculating the donor's taxable income for the year. This will provide a 100 per cent limit on the portion of a donation of appreciated property that must be included in the donor's taxable income.

The first change will encourage larger donations to charitable organizations. The second change will facilitate planned giving in circumstances where the gift is large relative to income in the last two years of life. The third change will ensure that taxpayers making gifts of appreciated capital are able to claim tax credits for the full amount of the taxable capital gain. These credits thereby offset the tax liability arising from that gain in the year in which the donation is made, which could otherwise create cash-flow difficulties for the taxpayer.

This proposal will apply to donations claimed for the 1996 and subsequent taxation years.

Tax Assistance for Education

Increasingly, achieving higher education and continuously updating skills is essential to securing a prosperous future for Canadians. Tax assistance to students and those supporting them helps Canadians meet these challenges.

Education credit and limit on transfer of credits

At present, the following tax relief is available to students in Canada:

- a credit based on an education amount of $80 for each month in which an individual is enrolled as a full-time student;
- a credit in respect of tuition fees; and
- an exemption of $500 of scholarship, fellowship or bursary income.

In addition, if a student has insufficient income to take full advantage of the education and/or tuition fee credits, they may be claimed by a supporting spouse, parent or grandparent, up to a maximum of $680. This transfer of up to $4,000 in tuition fee and education amounts recognizes that some students are not in a taxable position and are supported by their family.

In recent years students have faced significant increases in the cost of post-secondary education, primarily as a result of rising tuition fees. In order to provide additional assistance to students to help defray the costs of higher education, the budget proposes to increase the education amount by 25 per cent, from $80 per month to $100 per month. This change will benefit 900,000 students claiming the education credit.

The value of the tuition fee credit rises automatically in line with tuition fees. To allow spouses, parents or grandparents who support students to take advantage of the increased education credit and the increased value of the tuition fee credit, the budget proposes to increase the limit on the transfer of these credits by 25 per cent, from $680 to $850. This respresents an increase from $4,000 to $5,000 in the tuition fee and education amounts which may be transferred. Almost 700,000 taxpayers took advantage of a transfer of tuition or education credits in 1993.

These changes will be effective for the 1996 and subsequent taxation years.

Registered education savings plans (RESP)

Registered education savings plans have been recognized under the *Income Tax Act* since 1974. Under these plans, individuals make contributions which are held in trusts in order to generate income to be used to finance the post-secondary education costs of the trust beneficiaries. Contributions to registered education savings plans are not deductible from the income of the contributor, and may be returned to the contributor tax-free. However, the income generated by the contributions is tax-sheltered until paid out to named beneficiaries, when it is taxed in the beneficiaries' hands.

To ensure that the amount of tax-assisted savings sheltered by an RESP bears a reasonable relationship to the costs of post-secondary education, there is an annual limit of $1,500 on contributions to an RESP. Total contributions in respect of a beneficiary cannot exceed $31,500 over the lifetime of the plan, and all registered plans must be wound up after 25 years.

In light of increasing tuition costs, the budget proposes to increase the annual limit on RESP contributions to $2,000, and the lifetime limit per beneficiary to $42,000.

At present, a beneficiary of an RESP cannot simultaneously receive assistance for education purposes from another grantor at arm's length, unless the assistance is in the form of a scholarship or student loan. The budget proposes to remove this restriction.

These changes will be effective for 1996.

Child care expense deduction

The budget proposes to broaden eligibility for the child care expense deduction through three measures:

Single parents attending school full-time

As a general principle, the child care expense deduction is provided only in respect of child care services provided to enable an individual to earn income. Also, the deduction may be claimed only against earned income.

An exception to this principle applies to two-parent families where one spouse is a full-time student while the other is in the workforce. In this case, the working spouse may claim a deduction while the other spouse is studying.

The budget proposes to provide parallel assistance to single parents studying full-time by allowing them to claim the child care expense deduction against all types of income.

Child care expenses incurred by a single parent in order to attend school full-time will be deductible against all types of income (to a maximum of $150 per child under seven and $90 for older eligible children, multiplied by the number of weeks during which the supporting parent is in full-time attendance at school). This new measure will also apply to two-parent families when both parents are attending school full-time at the same time.

This new measure will assist parents, and particularly single parents, to undertake education or retraining, thus helping them to increase their earnings and achieve economic independence.

Recognizing full-time attendance at secondary school

The budget proposes that attendance in high school be recognized for the purpose of the child care expense deduction. This will be applied equally to two-parent and single-parent families.

For the purpose of the child care expense deduction, full-time attendance at school is defined as enrolment in a program of at least three consecutive weeks duration, which requires that the individual spend at least 10 hours per week on courses or work in the program.

Extension of the age limit

The budget proposes that the age limit for children with respect to whom the child care expense deduction may be claimed will be raised from 14 to 16 years.

Current allowable amounts will be maintained. The maximum yearly deductions will be the lesser of two-thirds of the taxpayer's earned income and the total of $5,000 per child under seven and $3,000 per child aged 7 to 16.

The increase in the age limit for the child care expense deduction responds to concerns raised mainly by single parents who must be away from home at night for their work (airline attendants, nurses and other shift workers).

All the above changes will apply for 1996 and subsequent taxation years.

Business Income Tax Measures

Overview

The business tax measures included in this budget better target the special tax provisions affecting the oil and gas and mining industries. The changes affect the resource allowance, flow-through shares, and accelerated capital cost allowances for mining activities. A number of changes are also proposed that will enhance investment in renewable resources. Taken together, the measures ensure that Canada continues to have a tax regime conducive to investment and consistent with the objectives of sustainable development.

Table A5.4
Business taxation measures

	1996-97	1997-98	1998-99
Resource sector			
Tighten flow-through shares for non-renewable sector	15	20	20
Extend 60-day rule for flow-through shares	–	–	–
Repeal Joint Exploration Corporation rules	–	–	–
Oil sands – qualifying mine expansions	-5	-5	-5
Broaden investor base for renewable energy	0	-5	-10
Expand flow-through shares to renewable energy	–	–	–
Total impact on resource sector	10	10	5
Other			
Extension of temporary tax on large deposit-taking institutions	25	40	–
Overseas employment tax credit	10	10	10
Total business taxation measures	45	60	15

Updates are provided in the areas of information technology scientific research and experimental development, the taxation of life insurance companies, and recently released foreign reporting requirements.

Additional revenue measures include the extension of the temporary tax on the largest deposit-taking institutions, as well as tightening the Overseas Employment Tax Credit.

Resource Sector

Resource allowance

The *Income Tax Act* currently provides a resource allowance equal to 25 per cent of a taxpayer's annual resource profits computed before the deduction of exploration expenses, development expenses and interest expenses. The resource allowance recognizes the non-deductibility of Crown royalties, mining taxes and other charges related to oil and gas or mining production.

Background

The deduction of Crown royalties and mining taxes paid to provincial governments in respect of mining and petroleum production was eliminated for federal income tax purposes in the May 1974 budget. This change was made primarily to ensure that rapidly rising petroleum royalties did not erode the federal income tax base.

The resource allowance was announced in the June 1975 budget. At that time, the government's two stated objectives in introducing the resource allowance were:

- "to meet, at least in part, the request for some form of deductibility in the tax system for provincial resource levies," and
- "to offer more incentive to those who explore and develop in Canada and to impose a greater tax liability on those who do not."

The measure was effective from January 1, 1976. It replaced the income tax abatements for mining and petroleum activities put in place in 1974 and 1975.

The February 1995 budget announced a consultative review of the resource allowance between the federal government, the provinces and affected industries to identify possible improvements to or replacements for the resource allowance.

A number of options were put forward, including allowing full deductibility of provincial royalties and mining taxes. Under this option, federal income taxes in the oil and gas sector would have decreased while revenues from mining would have increased. In addition, if royalty deductibility were re-instituted, the federal

government would effectively tax back any royalty reductions provided by provincial governments. The current resource allowance regime effectively disentangles federal income tax and provincial royalty systems, leaving the provinces with greater flexibility in managing their natural resources. This policy flexibility is important for new projects, such as those on the east coast, with lower net profit royalties.

Another option discussed was the replacement of the resource allowance structure with a lower tax rate, similar to that provided to the manufacturing and processing sector. This approach would have increased the overall federal tax liability, as well as increasing the after-tax cost of exploration and development activities and interest expenses.

The conclusion from the consultations was that most corporations in these sectors, along with most provinces, generally preferred the current resource allowance structure even though industry recognizes that it is an artificial construct.

This budget announces clarifications and proposes changes to the resource allowance calculation to provide more certainty in its application. Most of the key features of the current system are retained. In particular, the basic resource allowance deduction will be maintained at a rate of 25 per cent. Canadian Exploration Expenses (CEE) and Canadian Development Expenses (CDE), and interest expenses will continue to receive preferential treatment relative to other resource-related expenses.

Clarifications

The income tax rules will clarify that, in general, a deduction claimed in computing income will result in a reduction of resource profits for resource allowance purposes unless the expense is reasonably allocable to a non-resource activity. A number of other tightening changes will be made. These are explained in detail in a press release tabled by the Minister of Finance with the budget. These latter changes are generally effective after March 5, 1996.

Proposed changes

As part of the ongoing efforts to improve the resource allowance structure, the budget proposes that:

- Rules be developed in order to treat resource losses in a fashion symmetrical with resource profits. The creation of resource losses with no offset against subsequent resource profits is recognized as an anomaly in the current structure.
- The definition of resource income be expanded to include income from natural gas processing facilities. This will minimize current problems related to the demarcation between resource and processing activity.
- It is proposed that these changes take effect after December 31, 1996.

These changes, along with the other technical changes to the resource taxation rules released in the above-noted press release, will provide a more consistent and stable resource allowance calculation.

Finally, the government has asked the Technical Committee on Business Taxation to assess the resource tax provisions as part of its review of the business tax system which is focused on encouraging investment, creating jobs, and simplification.

Flow-through shares

Flow-through shares (FTS) are tax-based financing incentives available only to the oil and gas and mining sectors. The current rules effectively permit corporations to renounce income tax deductions associated with certain activities to investors in exchange for the sale of their shares.

Current provisions for flow-through shares

A flow-through share is a financing arrangement whereby an investor provides funds to a corporation that uses them to incur Canadian Exploration Expenses (CEE), Canadian Development Expenses (CDE) or Canadian Oil and Gas Property Expenses (COGPE). The investor receives shares issued by the corporation as consideration.

The effect of the FTS rules is to allow a corporation to renounce resource expenditures to the shareholders who have provided the funding for the expenditures. These financing arrangements are of most benefit to corporations that are not currently taxable.

The budget proposes changes to the FTS mechanism to better target the incentive to exploration and development activities and to end certain abuses. The budget also proposes that issuers will have an additional period in which to make the expenditures that have been flowed through to the investor.

Tightening measures

The budget proposes to introduce several new tightening measures to better focus the tax incentives for FTS. These tightening measures will ensure that FTS are only used to finance more risky expenditures, such as exploration and development costs. Canadian Oil and Gas Property Expenses (COGPE) and those Canadian Development Expenses (CDE) that relate to the cost of mining properties will no longer be eligible FTS expenditures. These expenses are related to properties and usually can be more easily financed in other ways than is the case for expenses for exploration and development.

Reclassification of oil and gas CDE via an FTS agreement

In 1992, a measure was introduced to assist junior oil and gas companies in raising flow-through share financing. The measure allows certain development expenses to be treated as CEE in the hands of an FTS investor. Consequently, an investor is entitled to a 100-per-cent write-off for CEE, rather than only a 30 per cent write-off for CDE. Current legislation provides for a $2 million annual limit on the amount of expenditures that a corporation or a group of associated corporations may reclassify.

The budget proposes to reduce the amounts of oil and gas development costs that can be reclassified as CEE under an FTS agreement from $2 million to $1 million per year and restrict the reclassification to issuing corporations with less than $15 million in taxable capital employed in Canada, as defined for the purposes of the Large Corporations Tax.

This change will better focus this incentive to smaller oil and gas companies who have a relatively greater need for assistance in raising new equity capital.

Seismic

Seismic testing is used to delineate possible oil and gas structures below the surface. Seismic testing normally uses shock waves set off by a series of explosions, and records signals using monitoring devices on the surface. The presence of geological structures in the subsurface can be assessed from this information.

Off-the-shelf seismic normally refers to seismic information that already exists from previous seismic testing. This off-the-shelf information can be resold in subsequent years by companies for further use and reprocessing.

The final tightening measure relates to the treatment of seismic costs. The budget proposes to deny FTS treatment for certain seismic expenses. "Off-the-shelf" seismic costs will no longer be eligible for FTS. This measure will reduce the opportunity for tax shelter abuses that have taken place due to their valuation.

The tightening measures will generally affect renunciations made after March 5, 1996, subject to certain grandfathering provisions.

Joint exploration corporations

The *Income Tax Act* permits joint exploration corporations (JECs) to flow deductions back to their shareholders. The JEC rules were introduced in 1962 as a vehicle for corporations to pool their resources to explore for and develop oil and gas and minerals.

Joint exploration corporations

A joint exploration corporation is a principal business corporation with fewer than 11 shareholders. A JEC may renounce exploration and development expenses to its shareholder corporations on the basis of payments or loans made by the shareholder corporation to the JEC. It permits the use of a separate corporation to explore and develop while its parent companies are able to utilize the write-offs for its resource expenditures.

As a result of information that has become available through the tax shelter reporting rules, the government has concluded that the JEC rules are being used primarily to dispose of resource properties in a tax-advantageous manner, rather than significantly assisting in the pooling of capital and expertise.

The budget proposes to terminate the JEC rules. This measure applies to renunciations made after March 5, 1996, subject to certain grandfathering provisions.

Flow-through shares – 60-day rule

The budget proposes changes to the FTS rules which will allow more time for companies to undertake certain resource expenditures related to flow-through share financing.

Current 60-day provision (look-back rule)

Flow-through shares (FTS) are generally bought by individuals who report income on a calendar year basis. Unlike RRSPs, an investor must purchase an FTS by December 31st to qualify for a deduction. However, the issuer has until the end of the first 60 days of the following year to incur eligible resource expenditures.

This look-back rule means an FTS investor can use the deduction for resource expenditures incurred in the first 60 days of the following year to reduce income tax in the current year.

The budget proposes to extend the FTS look-back rule so that an FTS issuer can make renunciations in a calendar year in respect of eligible resource expenditures which the FTS issuer plans to incur in that year. The issuer will be required to pay deductible monthly charges in respect of any unspent funds. The monthly charge will be calculated, beginning with the month of February, as a specified percentage of the portion of FTS funds that has not been spent on qualifying resource expenditures as of the end of that month. The specified percentage is equal to $1/12$ of the interest rate (which is presently 9 per cent) that is used for the purposes of determining refund interest under the Act. This charge effectively offsets the interest cost to the government of permitting a deduction in advance of an expense being incurred.

In the event that an FTS issuer does not expend the balance of FTS funds on qualifying resource expenditures by the end of the calendar year of the renunciation, the issuer will be required to adjust the renunciations made to the investors. In addition, the issuer will pay a charge of 10 per cent of the balance unexpended by the calendar year-end. This fee recognizes that costs will be incurred by the government in carrying out reassessments. These reassessments ensure the integrity of the FTS program by continuing to require investors to carefully scrutinize their investments in flow-through shares. An investor will not be required to pay interest to the government on any resulting increase in income tax payable as a result of such a reassessment until after April of the calendar year following the renunciation.

These changes apply to renunciations made after 1996.

CCA for new mines, mine expansions and in-situ oil recovery projects

The income tax rules for the mining sector have evolved over a number of years and recognize the high risk nature of the industry. These rules include an accelerated capital cost allowance (CCA) in respect of the cost of new mines and mine expansions.

CCA for mining equipment

The CCA rate for most equipment acquired by mining companies is 25 per cent, calculated on a declining balance basis (Class 41). An additional CCA may be claimed in respect of capital expenditures for structures and equipment with respect to a *new* mine to the full extent of income from that mine. Similarly, this treatment is provided to a major expansion of an existing mine (defined as a 25 per cent or greater increase in mine or mill capacity). The result is that the cost of any capital expenditures on related structures and equipment can be deducted to the extent of income from the entire mine at such time as the expansion becomes available for use.

The existing rules for accelerated CCA for new mines and major mine expansions are being relaxed to permit mining companies to claim accelerated CCA when they undertake large capital expenditures in a year but do not satisfy the existing criteria of a 25 per cent expansion in capacity.

In particular, the budget proposes that expenditures on depreciable property included in Class 41 in a year in respect of a mine in excess of five per cent of gross revenue from the mine for the year will qualify for the accelerated CCA (i.e. Class 41(a)). These changes will apply to all mining activities carried out in Canada, including oil sands mines. The changes will also allow capital expenditures for efficiency projects in excess of the five-per-cent threshold to qualify for the same treatment as those for new mines and major mine expansions.

Oil sands

Oil sands are a mixture of sand, clay, water and bitumen. Bitumen is generally described as a form of heavy oil with a density of less than 10 degrees API. In its natural state, bitumen is too viscous to be recovered through a well. Canada's known oil sands are located virtually entirely within the province of Alberta in three well-delineated areas known as the Athabasca-Wabasca, Peace River and Cold Lake deposits.

Oil sands occur at varying depths ranging from surface outcroppings to hundreds of metres below ground level. Deposits which lie more than 80 metres deep can currently be exploited only by "in-situ" extraction. "In-situ" extraction involves introducing sufficient heat into the oil sands to reduce the viscosity of the bitumen, thus allowing it to flow and be recovered via a well.

For tax purposes, oil sands projects which employ surface mining are treated as mines, while those which employ "in-situ" extraction are treated as oil wells. Given that the two extraction techniques produce a similar product, the budget proposes that tangible capital expenditures for oil sands "in-situ" projects be treated in the same manner as tangible capital expenditures for oil sands mining projects.

These changes will be applicable to all eligible expenditures incurred after March 6, 1996.

Environment

Incentives to invest in renewable energy

The budget proposes to improve access to financing for the renewable energy and energy conservation sector by relaxing the "specified energy property" rules and expanding eligibility for flow-through shares (FTS). These changes will provide an essentially level playing field in the energy sector and recognize the importance of renewable energy to Canada's overall energy supply needs. The development of renewable energy sources will better position Canada in meeting its long-term energy demands and its international commitment to reduce CO_2 levels.

Specified energy property

Under the current rules, eligible renewable energy and energy conservation equipment is entitled to the same rate of capital cost allowance (CCA) as manufacturing and processing equipment (30 per cent). This eligible equipment includes certain types of cogeneration equipment, mini-hydro facilities, equipment to generate electricity from wind, solar and geothermal sources and certain equipment used to generate energy from waste.

The CCA rules pertaining to these assets contain restrictions known as the "specified energy property" rules. These rules limit the ability to market investments in such property as tax shelter investments.

Specified energy property rules

The "specified energy property" rules were originally introduced in 1988. These rules limit the amount of capital cost allowance (CCA) that may be deducted by passive investors in respect of "specified energy property" to the income from such property. In this way, the accelerated CCA deductions provided for such equipment cannot be used by these taxpayers to shelter other sources of income, similar to the rules applicable to rental and leasing properties.

These rules do not apply, however, to taxpayers who use the property in their own businesses (other than the business of selling the product of that property) or to earn income from property (other than the specified energy property). For example, a farmer who installs a wind turbine to generate electricity, primarily (more than 50 per cent) for use in the farming business, is exempt from the specified energy property rules. Similarly, these rules do not apply to corporations the principal business of which is the sale, distribution or production of energy in general.

The budget proposes to relax the "specified energy property" rules in order to permit corporations whose principal business is manufacturing and processing (M&P) or mining to claim CCA deductions in respect of such property against income from all sources.

This change will encourage more investments in renewable energy and energy conservation projects and will increase the environmental benefits and job creation associated with them.

The changes to the "specified energy property" rules will come into force for property acquired after March 6, 1996.

Flow-through share financing

The FTS mechanism is designed to be of principal benefit to non-taxpaying junior resource companies. Many of these companies are unable to utilize income tax deductions for exploration and development and their access to alternative sources of financing is limited.

The renewable energy sector faces difficulties in financing intangible costs such as feasibility studies and pre-construction development expenses to determine the location, extent and quality of eligible renewable energy sources for the generation of electricity from wind and geothermal sources. These costs are similar to those incurred by junior resource companies.

Therefore, the budget proposes to make the tax treatments of renewable and non-renewable energy sectors more similar by:

- introducing a new category of expenditures (namely, Canadian Renewable and Conservation Expenses (CRCE)) in respect of intangible costs that are analogous to those expenses that are renounced as Canadian Exploration Expenses, and are associated with the development of projects, the equipment for which is eligible for Class 43.1 treatment;
- allowing this new class of expenditures to be fully deductible; and
- allowing these expenditures to be renounced to shareholders who have entered into an FTS agreement.

These changes will provide the renewable energy and energy conservation sector with improved access to financing in the early stages of their operations when they may have little or no income to utilize the income tax deductions related to these expenses.

The introduction of the new category of expenditures (i.e. CRCE) will take effect only after the definition of eligible costs has been developed in consultation with Natural Resources Canada and industry representatives.

Energy efficiency investments

The government also recognizes the importance of energy efficiency investments in achieving its environmental and economic objectives. However, more work is required to define the appropriate policy measures that will ensure a level playing field with respect to these types of investments. The Department of Finance and Natural Resources Canada will examine and consult on specific tax and other options to improve the treatment of energy efficiency investments and investments providing heating and cooling from renewable energy sources. An important element of these consultations will be the link between tax measures and the development of recognized standards for energy using equipment and structures. The consultations will be undertaken with a view to implementing new measures in the next budget.

Environmental trust funds

The 1994 budget introduced changes to the income tax rules for contributions to provincially mandated mine reclamation funds in order to:

- alleviate the cash-flow problem associated with contributions to provincially-mandated mine reclamation funds; and
- better match income and expenses relating to a mining operation.

The changes allow the contributions to qualifying mine reclamation funds to be tax deductible. The earnings of these funds are taxable.

That budget also established criteria for a qualifying mine reclamation trust fund including:

- the requirement that the trustee of a qualifying trust be limited to a government or third party trustee; and
- that the taxpayer be directly liable for any future reclamation.

Environmental trust funds

Environmental trust funds are funds established by companies to help finance future environmental commitments (i.e. reforestation, waste disposal site clean-ups).

Under current income tax rules, contributions by a taxpayer to environmental trust funds established to finance future reforestation work, waste disposal sites or sand and gravel pits would not qualify for a deduction in computing income for tax purposes because the contribution would only be used in the future to satisfy the taxpayer's obligations. This is similar to the situation that faced the mining industry prior to the announcement in the 1994 budget.

Given the similarity between environmental trust funds and mine reclamation funds, the government will examine the appropriateness of extending the mine reclamation trust rules to other sectors. Reviews will be undertaken on a sector-by-sector basis in consultation with provincial governments.

Technology

Review of information technology SR&ED

The 1995 budget announced a review of the income tax rules and administrative guidelines relating to the eligibility criteria for scientific research and experimental development (SR&ED) in the area of information technology. This review was undertaken through extensive consultation with the information technology SR&ED community. Computer software development was identified early in the review process as an area of particular concern.

The current system of income tax incentives for SR&ED is widely recognized as providing one of the most favourable investment climates for research and development in the world. SR&ED in the area of information technology has grown significantly in recent years and provides important benefits for Canada. Considerable support was expressed during the review process not only for Canada's system of SR&ED tax incentives but also for a restatement of the policy underlying the incentives.

Why government assists SR&ED

The benefits of SR&ED extend beyond the performers themselves to other firms and sectors of the economy. These "spillover" benefits mean that, in the absence of government support, firms would likely perform less SR&ED than is desirable from the economy's point of view.

Federal tax policy objectives in supporting SR&ED are to:

- encourage SR&ED to be performed in Canada by the private sector through broadly-based support;
- assist small businesses to perform SR&ED;
- provide incentives that are, as much as possible, of immediate benefit;
- provide incentives that are as simple to understand and comply with and as certain in application as possible; and
- promote SR&ED that conforms to sound business practices.

Federal tax incentives for SR&ED assist the private sector in developing new products and processes, improving productivity, enhancing competitiveness and growth, and creating jobs for the benefit of all Canadians.

The review examined information technology SR&ED in the context of the three basic criteria that any SR&ED claim must meet in order to qualify for the tax incentives, namely:

- scientific or technological advancement;
- scientific or technological uncertainty; and
- scientific and technical content.

The review found that these three criteria can be applied successfully to information technology SR&ED. However, the review also determined that it is very important that these criteria be applied consistently and that the administrative guidelines reflect the rapid changes that have been occurring in this area. Revenue Canada is, therefore, currently updating and clarifying its administrative guidelines relating to the eligibility of work in the area of computer software development. The SR&ED community will be fully consulted before these guidelines are finalized. Information and documentation requirements relating to the SR&ED tax incentives will be enforced rigorously.

The 1995 budget also proposed that information technology SR&ED performed by financial institutions would be excluded from the SR&ED tax incentives pending completion of the review. As indicated above, the review found that any difficulties in applying the basic criteria to information technology SR&ED performed by financial institutions can be resolved through the proper application of these criteria and guideline revisions. In particular, Revenue Canada's initial assessment indicates that much of the work underlying the claims of financial institutions does not meet the basic criteria and, therefore, would not qualify for SR&ED tax incentives. Accordingly, there is no need to provide differential income tax treatment for information technology SR&ED performed by financial institutions (as was proposed in the Notice of Ways and Means Motion tabled on December 12, 1995).

The Department of Finance and Revenue Canada are undertaking a joint evaluation of the federal income tax incentives for SR&ED as was indicated in the 1995 budget. This evaluation will be completed later this year. The evaluation is assessing the relevance, impacts and effects, and cost-effectiveness of the SR&ED tax incentives while the review of information technology SR&ED focused on eligibility criteria.

Modifications to the SR&ED tax incentives

The budget proposes a number of changes that will improve the effectiveness of the income tax incentives for scientific research and experimental development (SR&ED).

SR&ED: Assignment of certain income tax refunds

In the past, corporations could assign expected refunds of SR&ED investment tax credits to lenders as security for bridge financing for their operations. However, recent jurisprudence has held that income tax refunds are not generally assignable. As a result, borrowers are not able to use expected refunds of investment tax credits as security for loans.

It is therefore proposed that the *Income Tax Act* be amended to facilitate access to this financing option for companies (as well as for interim financing of the Canadian Film or Video Production Tax Credit proposed in the 1995 budget) while not prejudicing the rights that the government currently has with respect to debts owing by the borrower to the government.

This measure will be effective for assignments made after March 5, 1996.

SR&ED: Payments to specified employees

Specified employees are persons who do not deal at arm's length with their employer or who have a significant interest (i.e. 10 per cent or more) in the shares of their employer. For the purpose of the SR&ED tax incentives, the wages and salaries of specified employees should reflect the value of the SR&ED work the employees perform for the firm as opposed to the profitability of the corporation as a whole.

To better achieve this objective, the budget proposes to limit the amount of wages and salaries eligible for the SR&ED tax incentives in the case of specified employees. This limit will be five times the year's maximum pensionable earnings for the purposes of the Canada Pension Plan (i.e. about $180,000 in 1996).

This measure will be effective for taxation years that begin after March 5, 1996.

SR&ED: Rental payments in respect of buildings

Expenses relating to the acquisition or rental of buildings were made generally ineligible for the SR&ED tax incentives after 1987. However, transitional relief was provided for rental payments in respect of leasehold agreements entered into before June 18, 1987.

Taxpayers with such leases have benefited for almost nine years from this transitional provision. In order that all taxpayers having leasehold interests in buildings used for SR&ED be subject to the same set of rules, this transitional provision will be terminated for taxation years commencing after March 5, 1996.

Updates

Taxation of life insurance companies

A number of changes to the taxation of life insurance companies will take effect in the 1996 taxation year. These changes are the result of extensive consultations with the industry. The objective is

to improve the income tax rules so that the dependence on capital taxes will eventually be reduced and more revenues will be raised through income taxes.

The changes will affect both the calculation of life insurers' reserves and the calculation of the Canadian component of the income of multinational insurers. Specifically:

- Most reserves on life insurance policies issued after 1995 will be equal to the reserves reported in financial statements. Pre-1996 policies will be fully grandfathered.
- The method of measuring Canadian income will be improved by using a full balance sheet approach.
- To ensure that tax revenues are not reduced in the short-term, the additional capital tax currently levied on life insurance companies will be extended for a further three years.

The changes are intended to be revenue neutral. Over time, life insurance companies will pay more income taxes and less capital taxes. Draft legislation and regulations giving effect to the changes will be released later this year.

Foreign reporting requirements

The 1995 budget announced the introduction of new foreign reporting requirements. These requirements apply to taxpayers who own foreign property or shares of foreign affiliates or who transfer property to or receive distributions from a non-resident trust. These new reporting requirements will be effective for taxation years that begin after 1995. These reporting requirements will support Revenue Canada's administrative and enforcement efforts in this area and, ultimately, help ensure that Canadians pay an appropriate amount of tax on income accruing with respect to foreign property holdings. On March 5, 1996, Revenue Minister Jane Stewart and Finance Minister Paul Martin jointly released draft legislation and draft information returns to implement the reporting requirements previously announced. Taxpayers and their advisors have been asked to comment on the proposals. It is anticipated that these measures will be introduced in a bill later this year.

Banks and Other Large Deposit-Taking Institutions

Extension of the temporary capital tax surcharge on large deposit-taking institutions

The temporary capital tax surcharge on large deposit-taking institutions, which was introduced in the 1995 budget and which is scheduled to expire on October 31, 1996, will be extended until October 31, 1997.

This temporary surcharge applies to financial institutions as defined under Part VI of the *Income Tax Act*. However, it does not apply to life insurance companies as it is proposed that the special tax applying to life insurers under Part VI continue to apply until the end of 1998. The surcharge will continue to apply at a rate of 12 per cent of the capital tax imposed under Part VI calculated before any credit for income taxes and with a capital deduction of $400 million. The surcharge is also not eligible to be offset by tax payable under Part I of the Act.

For taxation years that include October 31, 1997, the surcharge will be prorated on the basis of the number of days in the taxation year that are before November 1, 1997.

Other

Overseas employment tax credit

Section 122.3 of the *Income Tax Act* provides a tax credit to Canadian residents who are employed outside Canada by a specified employer for at least six months in connection with resource, construction, installation, agricultural or engineering contracts or for the purpose of obtaining those contracts. This credit – commonly known as the Overseas Employment Tax Credit (OETC) effectively eliminates 80 per cent of the Canadian tax arising on the first $100,000 of salary or wages earned from such foreign employment.

The primary purpose of this credit is to ensure that Canadian firms, employing Canadian staff, are in a position to compete against foreign firms in bidding on overseas work. The tax systems of a number of countries other than Canada provide tax relief to their residents working abroad, thus allowing firms from those countries to base their bids for overseas contracts on the reduced salary costs that such tax relief allows. Similarly, the OETC enables

Canadian employers to reduce their employment costs with respect to foreign contract work, while maintaining the after-tax value of the remuneration their employees receive in connection with such work.

Since the substantial benefits that the OETC provides are intended to enhance the competitiveness of Canadian firms through lower wage bills, rather than to serve as an incentive for individuals resident in Canada to work offshore, the credit is limited to income from an employer that is resident in Canada or a foreign affiliate of a Canadian resident. However, a Canadian individual who is to be employed by a foreign firm can attempt to take advantage of the credit by creating a Canadian firm which would then contract with the foreign firm to provide the individual's services. The Canadian firm could then "employ" the individual to provide the services to the foreign firm and, assuming that the services are provided in connection with a qualifying activity, the individual could claim the OETC on the basis that his or her income came from a Canadian resident.

To ensure that the credit is not available in such cases, the budget proposes that section 122.3 of the *Income Tax Act* be modified to deny the OETC for an individual's employment income from an employer where, but for the employer's existence, services which the employer has contracted to provide to another person would have been provided by the individual as that other person's employee. Eligibility of such income for the OETC will not, however, be denied unless:

- the employer carries on a business of providing services, but does not employ more than five full-time employees in that business; and
- the individual is related to, or is a specified shareholder of, the employer or, if the employer is a partnership, the individual is related to, or is a specified shareholder of, a member of the partnership. Generally, if an individual or a non-arm's length person owns 10 per cent or more of any class of a corporation's stock, the individual is a specified shareholder of the corporation.

This modification is to take effect for the 1997 and subsequent taxation years.

Excise Tax Measures

Excise Tax on Split-Run Magazines

In December 1995 the *Excise Tax Act* was amended to impose an excise tax on split-run magazines. The tax is payable by either the publisher, a person related to the publisher, the distributor, the printer or the wholesaler of the magazine. The taxpayer is the first person on this list who is resident in Canada.

Some concern has been expressed that magazine distributors, printers and wholesalers could face a tax liability on an issue before they are reasonably able to determine whether a particular magazine is a split-run magazine. To give potential taxpayers more time to become aware of new split-run titles before incurring tax liability, the budget proposes to exempt from the tax the first split-run issue of a magazine if the person who would otherwise be responsible for paying the tax is the distributor, printer or wholesaler. This exemption will apply to magazines published after March 6, 1996.

Notice of Ways and Means Motion to Amend the *Income Tax Act*

That it is expedient to amend the *Income Tax Act* to provide among other things:

Education tax credit

(1) That, for the 1996 and subsequent taxation years, the monthly amount on which the education tax credit is calculated be increased to $100 from $80.

Transfer of tuition fee and education tax credits

(2) That, for the 1996 and subsequent taxation years, the maximum amount that can be transferred by a student to a spouse or supporting individual in respect of the student's tuition fee and education tax credits be increased to $850 from $680.

Child care expenses

(3) That, for the 1996 and subsequent taxation years, the child care expense deduction be modified to

(*a*) raise the maximum age of children in respect of whom the deduction may be claimed from under 14 years at any time during the year to under 16 years at any time during the year, and

(*b*) provide that, where an individual, during the year,

(i) attends an educational institution that is designated for purposes of the education tax credit or that is a secondary school in Canada, and

(ii) is enrolled in a program of the institution of at least 3 consecutive weeks duration that requires the individual to spend at least 10 hours per week on courses or work in the program

the calculation of the deduction will

(iii) include as eligible child care expenses amounts paid in respect of child care to a maximum of

(A) $150 for each child of the individual who is under the age of 7 years at the end of the year or in respect of whom a disability tax credit may be claimed, and

(B) $90 for each child of the individual who is over the age of 6 years and under the age of 16 years at any time during the year or who is dependent on the individual and has a mental or physical infirmity

per week that the individual attends the educational institution, and

(iv) include, in computing the income on which the deduction for the year is based, all amounts included in computing the individual's income for the year.

Child support

(4) That, for the 1997 and subsequent taxation years, the deduction available to a payer and the inclusion in income required of a recipient in respect of amounts of support or maintenance (including third-party payments) paid and received

(*a*) under a written agreement or court order, and

(*b*) on or after the commencement day of the payer and recipient

be limited to the amount, if any, determined by the formula

$$A - (B - C)$$

where

A is the total of all amounts of support or maintenance paid under the agreement or order on or after their commencement day and in the year,

B is the total of all amounts of child support that became payable under the agreement or order on or after their commencement day and before the end of the year, and

C is the total of all amounts of support and maintenance paid and received under the agreement or order on or after their commencement day and before the beginning of the year that were not deductible in computing the payer's income and not required to be included in computing the recipient's income,

and for the purposes of this paragraph

(*c*) "commencement day" of a payer and a recipient means the day, after April 30, 1997, on which an agreement or order is made, or where an agreement or order was made before May 1, 1997, the earliest of

(i) the day (which cannot be earlier than May 1, 1997) specified by the payer and recipient in a joint election filed with Revenue Canada,

(ii) the day, after April 30, 1997, on which the agreement or order is changed or varied to alter the amount of child support provided therein, and

(iii) the day (which cannot be earlier than May 1, 1997) specified in the agreement or order as the day on and after which the provisions of the Act implementing this paragraph are to apply, and

(*d*) each amount of support or maintenance payable under an agreement or order that is not identified in the agreement or order as being solely for the support of the recipient shall be considered to be an amount payable for child support.

Equivalent-to-married credit

(5) That, for the 1997 and subsequent taxation years, where an individual is required under the terms of a written agreement or court order to make payments in the year in respect of the support of a child, the individual not be entitled to claim any tax credit under section 118 of the Act in respect of the child.

Child Tax Benefit – working income supplement

(6) That the working income supplement component of the Child Tax Benefit be modified in respect of

(*a*) payments arising during months after June 1997 and before July 1998 by

(i) increasing the maximum annual benefit to $750,

(ii) changing the rate at which the supplement is phased in to 12% of adjusted earned income, and

(iii) changing the rate at which the supplement is reduced to 15% of adjusted income, and

(*b*) payments arising during months after June 1998 by

(i) increasing the maximum annual benefit to $1,000,

(ii) changing the rate at which the supplement is phased in to 16% of adjusted earned income, and

(iii) changing the rate at which the supplement is reduced to 20% of adjusted income.

Credit for infirm dependants

(7) That, for the 1996 and subsequent taxation years, the credit available to individuals under paragraph 118(1)(d) of the Act in respect of mentally or physically infirm dependants be modified to

(*a*) increase the amount on which the credit is calculated to $2,353, for a maximum credit of $400 (indexed for years after 1996), and

(*b*) increase the income level at which the credit begins to be reduced to $4,103 (indexed for years after 1996).

Charitable donations

(8) That, for the 1996 and subsequent taxation years, the annual income limitation for total charitable gifts be increased to

(*a*) 100% of an individual donor's income for the year in which the individual dies and for the preceding year, and

(*b*) in all other cases, the total of

(i) 50% of the donor's income for the year, and

(ii) 50% of the amount of taxable capital gains arising in respect of gifts of capital property included in the donor's taxable income for the year.

Overseas Employment Tax Credit

(9) That, for the 1997 and subsequent taxation years, the Overseas Employment Tax Credit in section 122.3 of the Act not apply in respect of an individual's income from employment by an employer

(*a*) that carries on a business of providing services, and

(*b*) that does not employ in the business throughout the year more than 5 full-time employees,

where

(*c*) but for the existence of the employer, the individual would reasonably be regarded as an officer or employee of the person or partnership to which the services were provided, and

(*d*) the individual is related to or is a specified shareholder of the employer or, where the employer is a partnership, the individual is related to or is a specified shareholder of a member of the partnership.

Pension and RRSP limits

(10) That, for purposes of the rules relating to registered pension plans, deferred profit sharing plans and registered retirement savings plans, the money purchase limit be changed, effective as of January 1, 1997, to:

(*a*) $13,500 for each year after 1996 and before 2003,

(*b*) $14,500 for 2003,

(*c*) $15,500 for 2004, and

(*d*) for each year thereafter, $15,500 indexed by the growth in the average wage in Canada.

Commencement age for RRSPs and DPSPs

(11) That

(*a*) the time by which an individual's registered retirement savings plan (RRSP) must mature be changed from the end of the year in which the individual attains 71 years of age to the end of the year in which the individual attains 69 years of age,

(*b*) the latest time by which amounts vested in an individual under a deferred profit sharing plan (DPSP) must become payable be changed from 90 days after the individual attains 71 years of age to the end of the year in which the individual attains 69 years of age, and

(*c*) the time by which an annuity purchased for an individual under a DPSP must commence be changed from the individual's 71st birthday to the end of the year in which the individual attains 69 years of age,

except that

(*d*) the deadlines described in subparagraphs (*a*), (*b*) and (*c*) be changed to the end of 1997 for an individual who is 69 years of age at the end of 1996,

(*e*) the changes not apply to an individual who is 70 years of age or older at the end of 1996, and

(*f*) the changes not apply to an RRSP or DPSP annuity contract that has a fixed commencement date and was acquired before March 6, 1996.

(12) That the provisions of the Act implementing paragraph (11) apply after 1996, except that an RRSP which is registered before 1997 not be required to be amended to comply with paragraph (11), but be deregistered if it does not mature by the time determined in that paragraph.

Lifetime carry-forward of unused RRSP deduction room

(13) That there be no restriction on the carry-forward of an individual's unused RRSP deduction room.

RRSP/RRIF administration fees

(14) That no amount paid after March 5, 1996 for investment counselling or administration services in respect of a registered retirement savings plan or registered retirement income fund be deductible in computing the annuitant's income.

Registered education savings plans

(15) That, for the 1996 and subsequent taxation years,

(*a*) the annual limit on the amount of total contributions to registered education savings plans in respect of a beneficiary be increased to the lesser of

(i) $2,000, and

(ii) $42,000 minus the total contributions made to all such plans in respect of the beneficiary for all preceding years, and

(*b*) for the purposes of section 146.1 of the Act, the definition "qualifying educational program" in subsection 118.6(1) of the Act be modified to remove the conditions contained in paragraph (a) of that definition.

Non-resident election to be taxed under Part I

(16) That, for the 1997 and subsequent taxation years, where a non-resident individual elects under section 217 of the Act to be taxed under Part I of the Act, the applicable tax rate be determined on the basis of the greater of

(*a*) the individual's taxable income earned in Canada, and

(*b*) the individual's income.

Labour-sponsored venture capital corporations (LSVCCs)

(17) That an individual's maximum LSVCC tax credit for the 1996 taxation year be the total of

(*a*) the lesser of $1,000 and the product obtained when 0.2 is multiplied by the total cost of LSVCC shares acquired after 1995 and before March 6, 1996 (other than the portion of the total in respect of which an amount was deducted in computing the individual's tax payable for the 1995 taxation year), and

(*b*) the lesser of

(i) the amount, if any, by which $525 exceeds the amount determined under subparagraph (*a*) in respect of the individual, and

(ii) the product obtained when 0.15 is multiplied by the total cost of LSVCC shares acquired after March 5, 1996 and before March 2, 1997.

(18) That, for the 1997 and subsequent taxation years,

(*a*) subject to subparagraphs (*b*) and (*c*), the maximum tax credit in respect of LSVCC shares acquired be reduced to 15% of the cost of the shares,

(*b*) the maximum tax credit in respect of LSVCC shares be further limited to the tax credit provided under the law of a province in respect of the acquisition of those shares, except that this subparagraph shall not result in the maximum tax credit in respect of shares issued by federally-registered LSVCCs being less than 10% of the cost of the shares, and

(*c*) the calculation of the maximum tax credit in respect of LSVCC shares ignore total acquisitions for the year in excess of $3,500.

(19) That, where an LSVCC share is redeemed after 1997 in circumstances to which clause 204.81(1)(*c*)(v)(F) of the Act applies,

(*a*) the shareholder be liable to pay an amount equal to the labour-sponsored funds tax credit that would, if any required information return were filed in respect of the share, be determined in respect of the acquisition of the share, and

(*b*) the LSVCC be required, on behalf of the shareholder, to withhold that amount from the proceeds of the redemption and remit it to the Receiver General for Canada.

(20) That the Minister of National Revenue be permitted to refund to an individual any amount payable under the Act by a shareholder in respect of a redeemed LSVCC share to the extent that such amount exceeds the LSVCC tax credit claimed by the individual under the Act in respect of any acquisition of the share.

(21) That, where a share issued by an LSVCC is redeemed after March 5, 1996 (otherwise than pursuant to subclause 204.81(1)(*c*)(v)(A)(I) or clause 204.81(1)(*c*)(v)(B) or (F) of the Act or in circumstances giving rise to the payment described in paragraph (19) or in proposed Part XII.5 of the Act), the individual who was eligible to claim an LSVCC tax credit in respect of the acquisition of the share not be entitled to claim an LSVCC tax credit for the taxation year in which the redemption occurred nor for either of the 2 following taxation years.

(22) That, for the 1996 and subsequent taxation years, subsection 127.4(4) of the Act be repealed.

(23) That, after 1996, the articles of an LSVCC be required to provide

(*a*) a minimum holding period, in circumstances to which clause 204.81(1)(*c*)(v)(E) or subparagraph 204.81(1)(*c*)(vi) of the Act applies, of 8 years for shares acquired after March 5, 1996,

(*b*) that the transfer of LSVCC shares, in circumstances to which clause 204.81(1)(*c*)(vii)(B) of the Act applies, not be registered in respect of shares acquired after March 5, 1996, and

(*c*) that redemptions after 1997 may be made in accordance with clause 204.81(1)(*c*)(v)(F) of the Act only if the LSVCC withholds amounts on behalf of the shareholder in accordance with the Act.

(24) That, after March 6, 1996, the articles of an LSVCC may provide that

(*a*) the LSVCC may redeem a share where the information return referred to in paragraph 204.81(6)(*c*) of the Act in respect of the share has been returned to the LSVCC, and

(*b*) where responsibilities in respect of an LSVCC are transferred from a particular eligible labour body to another eligible labour body,

(i) the business and affairs of the LSVCC may be managed in the one-year period beginning on the day of the transfer by a board of directors at least ½ of whom are appointed by the labour bodies and, after that period, by a board of directors at least ½ of whom are appointed by the other eligible labour body, and

(ii) Class B shares may be issued to the other eligible labour body.

Research and development

(25) That, for taxation years that begin after March 5, 1996, expenditures of a taxpayer on or in respect of scientific research and experimental development not include

(*a*) expenditures incurred in respect of the year for the use of, or the right to use, a building other than a prescribed special purpose building, and

(*b*) remuneration for the year in respect of a specified employee of the taxpayer in excess of 5 times the Maximum Pensionable Earnings under the Canada Pension Plan for the calendar year in which the taxation year ends, prorated based upon the number of days that the specified employee was an employee of the taxpayer and allocated amongst those corporations, of which the specified employee is an employee, that are associated with the taxpayer.

Flow-through shares

(26) That the flow-through share rules be changed so that

(*a*) after 1996, an issuer of a flow-through share can renounce in the first 90 days of a particular calendar year and effective as of the end of the preceding calendar year, such of the expenses described in subsection 66(12.66) of the Act as the issuer has incurred, or plans to incur, in the particular year, and

(*b*) a reduction in the amount that an investor is deemed to have incurred in respect of such a renunciation made in a calendar year

be provided to the extent that the renounced expenses are not incurred by the end of the year.

(27) That the investor in a flow-through share, or a member of a partnership that invests in a flow-through share, not be liable

(*a*) for any penalty levied under the Act because of a reduction referred to in subparagraph (26)(*b*) in respect of a renunciation, nor

(*b*) for any interest payable under this Act

(i) for the period before May of the year following the year in which the renunciation was made, and

(ii) that otherwise arises because of the reduction.

(28) That, where an issuer of a flow-through share does not incur renounced expenses by the end of the calendar year in which renunciations referred to in subparagraph (26)(*a*) are made,

(*a*) the issuer be obliged to revise the renunciations accordingly and file a statement with Revenue Canada on or before the 60th day after the end of the year indicating the adjustments made in the renunciations, and

(*b*) where the issuer knowingly, or under circumstances amounting to gross negligence, does not comply with its obligation to revise the renunciations, the issuer be liable to a penalty equal to 25% of the amount, if any, by which

(i) the total of the renounced expenses that have not been incurred before the end of the year

exceeds

(ii) such portion of the total reductions referred to in subparagraph (26)(*b*) in respect of those renounced expenses as are described in statements filed with Revenue Canada on or before the 60th day after the end of the year.

(29) That a corporation be liable to a charge for each month (other than January) that is deductible in computing income in respect of an issue by it of flow-through shares equal to the amount determined by the formula

$$(A - B) \times (C/12 + D/10)$$

where

A is the total of all amounts in respect of the issue that the corporation renounces pursuant to subparagraph (26)(*a*) in the first 90 days of the calendar year that includes the month,

B is the total of all expenses that were incurred by the corporation before the end of the month and that relate to those renounced amounts,

C is the rate of interest, determined under paragraph 4301(*b*) of the Income Tax Regulations, for the last quarter ending before the month, and

D is

(*a*) where the month is December 1, and

(*b*) in any other case, nil.

(30) That the cost of seismic data and any expenditure made for the use of seismic data not qualify as a Canadian exploration expense that can be renounced under the flow-through share rules, except where

(*a*) the cost was incurred, or the expenditure was made, before March 6, 1996 or pursuant to an agreement in writing made before March 6, 1996, or

(*b*) if neither the seismic data nor any right to use the seismic data had been previously acquired before the time that the cost was incurred or the expenditure was made, all or substantially all of the seismic data resulted from work performed no earlier than one year before that time.

(31) That subsection 66(12.62) of the Act not allow for the renunciation of the cost of a Canadian resource property that is referred to in paragraph (e) of the definition "Canadian development expense" in subsection 66.2(5) of the Act, except where the renunciation is made before 1999 in respect of consideration given before March 6, 1996 or given pursuant to an agreement in writing made before March 6, 1996.

(32) That subsection 66(12.64) of the Act be repealed in respect of renunciations made after March 5, 1996 (other than renunciations made before 1999 that are in respect of consideration given before March 6, 1996 or given pursuant to an agreement in writing made before March 6, 1996).

(33) That the $2 million allowance for expenses that can be reclassified by a corporation from Canadian development expense to Canadian exploration expense pursuant to subsection 66(12.601) of the Act.

(*a*) subject to subparagraph (b), be reduced to $1 million in respect of renunciations made after March 5, 1996, and

(*b*) be eliminated in respect of renunciations made after March 5, 1996 by a corporation whose taxable capital employed in Canada (within the meaning assigned by subsection 181.2(1) of the

Act) for its last taxation year that ended before the consideration in respect of the renunciation was given is more than $15 million,

except that this paragraph not apply to renunciations made before 1999 of expenses that are in respect of consideration given before March 6, 1996 or given pursuant to agreements in writing made before March 6, 1996.

Joint exploration corporations

(34) That no amount can be renounced under any of subsections 66(10) to (10.3) of the Act and subsections 29(6) and (7) of the Income Tax Application Rules by a joint exploration corporation

(*a*) after 2006, in respect of a payment or a loan received by the corporation before March 6, 1996,

(*b*) after 2006, in respect of a payment or a loan received by the corporation after March 5, 1996 pursuant to an agreement in writing made by the corporation before March 6, 1996, and

(*c*) after March 5, 1996, in any other case.

Resource allowance and other matters

(35) That the provisions relating to depreciable property and the calculation of Canadian exploration expenses, Canadian development expenses and foreign exploration and development expenses be changed in accordance with draft amendments tabled by the Minister of Finance in the House of Commons on March 6, 1996.

Part VI surtax

(36) That the 12% Part VI surtax on financial institutions (other than life insurers) be extended to October 31, 1997 (prorated for any taxation year that ends after October 1997).

Assignment of tax refunds

(37) That, after March 5, 1996, the assignment by a corporation of that part of an income tax refund that is attributable to an Investment Tax Credit or a Canadian Film or Video Production Tax Credit be effectual in law, subject to the following limitations:

(*a*) any such assignment will not be binding on Her Majesty and no liability will be created between the assignee and Her Majesty as a result of such an assignment, and

(*b*) the rights of the assignee will be subject to all equities and all statutory rights of set-off in favour of Her Majesty which would have had priority if there had been no such assignment.

Notice of Ways and Means Motion to Amend the *Excise Tax Act*

That it is expedient to amend the *Excise Tax Act* to provide that, effective March 7, 1996, the excise tax on split-run editions of periodicals not apply to the first issue of a split-run edition if the person who would otherwise be responsible for paying the tax in respect of the edition is the distributor, the printer or the wholesaler.